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STATUS BOUND: THE TWENTIETH CENTURY EVOLUTION OF DIRECTORS' LIABILITY

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INTRODUCTION

The board of directors is created by the state through its corporation statute and serves as a reminder of the public nature of the corporation. The bylaws or certificate of incorporation typically set the number of directors to be elected by the shareholders and the length of their terms (traditionally one year, but today many corporations have staggered boards). The board acts at meetings, typically by majority vote, and it can establish committees to act on its behalf. As a general matter, a corporation is to be managed by or under the direction of its board of directors.[1] Yet the scope of the board's role and duties, as well as the standard of liability by which its actions are evaluated, have remained unsettled throughout the twentieth century.

Literature discussing the board's role, duties, and liabilities is vast but, for the most part, limited to empirical studies, normative discussions, and policy arguments. My goal in this article is different. Rather than approaching the subject from an empirical, normative, or policymaking angle, I seek to add an important historical dimension to these analyses. This article examines scholarly conversations and judicial decisions, ranging from the turn of the twentieth century to its end, about the appropriate status of directors and the standard of liability that each status carried—specifically in situations involving allegations of breaches of the duty of care.[2] I argue that during the course of the twentieth century, jurists moved

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1. REV. MODEL BUS. CORP. Act §8.01(b) (2005); DEL. CODE. ANN. tit. 8, § 141(a) (2001). For a detailed analysis of the development of the corporate board, see Franklin A. Gevurtz, *The Historical and Political Origins of the Corporate Board of Directors*, 33 HOFSTRA L. REV. 89 (2004).

2. While little is left today of the director's duty of care (*see infra* Part IV), and while throughout the twentieth century very few cases held directors liable for breaching the duty of care, it is in relation to this duty that discussions of the directors' status and liabilities were most pertinent. I therefore focus on scholarly and judicial assessments of the duty of care. For an intriguing historical analysis of the transformation of the duty of loyalty, broadly defined, in New York, see William E. Nelson, *The Law of Fiduciary Duty in New York, 1920-1980*, 53 SMU L. REV. 285 (2000).

from viewing directors as trustees, to describing directors as representatives of the shareholders, to holding that directors were mere agents of shareholders who typically served as rather passive principals. Each of these labels implied a particular standard of liability—trustees were subjected to heightened requirements, directors as representatives were expected to act reasonably, while agents' decisions were subjected only to minimal scrutiny. As I further argue, academic and judicial definitions of the appropriate legal status of directors (and the corresponding liabilities) were influenced by different understandings of the role of corporations in society. The early-twentieth century idea that directors were trustees was influenced by the Progressives' concerns about the concentration of private and public power, the mid century notion that directors were representatives of the shareholders was informed by the ideals of democracy, while the late twentieth century description of directors as agents was influenced by market ideology.[3] In the end, however, each assigned status helped legitimate directors' (and executives') power and limited, if any, liability. The idea that directors were trustees helped legitimate the powerful public corporation, the notion that directors were representatives was used by the courts to justify their deference to directors' discretion, while the vision of directors as agents helped shield directors and executives from liability altogether.

3. I focus on scholarly and judicial discussions rather than on corporate statutes because, for the most part, important changes and developments were judge-made while the statutes attempted to codify them. *See, e.g.*, Kenneth K. Luce, *Trends in Modern Corporation Legislation*, 50 MICH. L. REV. 1291, 1316 (1952) (noting that "as a practical matter it may be fruitless to attempt direct legislation with respect to most aspects of the fiduciary duties of directors and majority shareholders to manage the corporation with care, diligence and loyalty, and this perhaps explains the general lack of legislation in the field"); William L. Cary and Sam Harris, *Standards of Conduct under Common Law, Present Day Statutes and the Model Act*, 27 BUS. LAW. 61, 64 (1972) (noting that "very generally almost all of the statutes in this area . . . [say] that directors shall discharge their duties with that degree of care which ordinarily prudent men would exercise under similar circumstances in like positions"); E. Norman Veasey and William E. Manning, *Codified Standard Safe Harbor or Uncharted Reef? An Analysis of the Model Act Standard of Care Compared with Delaware Law*, 35 BUS. LAW. 919, 923 (1980) (noting that statutes do not typically state what the role of the board is other than in very general terms).

The first part of this article sets the stage for my analysis of the twentieth century evolution of directors' status and liability by describing the emergence of the board of directors as an important institution with the development of the modern public corporation in the last decades of the nineteenth century. I begin by discussing courts' bifurcated analyses of directorial duties and liabilities that took place, almost literally, minutes before the rise of the giant modern public corporation. As I argue, some late nineteenth century jurists insisted that corporations were aggregations of individuals and directors were their agents. In the absence of a conflict of interest, fraud, or bad faith, directors, as agents, were liable to the corporation and its shareholders only when their actions were grossly negligent. In contrast, other jurists viewed corporations as real entities, existing separately and apart from their members, and capable of exercising power that resembled the power of the sovereign state. They proclaimed that directors were trustees for the community and examined their actions under an ordinary negligence standard.[4]

With the emergence of the giant public corporation during and after the merger wave of the late 1890s, discussions of the status of the board became situated in a broader public concern about corporate power and its potential abuse. As the second part of this article elaborates, scholarly focus centered upon the power that the control group (typically controlling shareholders) could exercise to manipulate stock prices and market transactions. Legal scholars, seeking to legitimate the large public corporation and its power while eliminating such abuses by the control group, turned their focus on directors; they wanted to vest directors with public power and public trust. The real entity vision of the corporation, coupled with the description of directors as trustees for the community, prevailed. Both ideas were grounded in the recognition that corporations and other associations were powerful, perhaps even sovereign, entities. The success of American democracy thus

4. While these jurists' claim that directors were trustees for the community anticipated late twentieth century discussions of directors' duties toward different corporate constituencies, the jurists' discussions did not focus on particular stakeholders; rather, they argued that corporate power should be exercised to benefit all those affected by it.

demanded recognition of their autonomy as well as limitations on their power.

By the early 1930s, the vision of the corporate director as trustee seemed to dominate legal discourse, but the victory was short-lived. As the third part of this article demonstrates, after the programs of the New Deal were put in place and the Great Depression wore down, concerns about corporate power dissipated. Discussions about the duties and liabilities of corporate directors became intertwined with a vision of corporate democracy that rested on the assumption that individual shareholders had to be protected from corporate management.[5] In reform literature beginning in the mid 1930s (and through the 1970s) and in the courts, directors were described as the shareholders' representatives and guardians against managerial abuses of power.[6] Such an understanding of the director's role seemed to correlate with a lower standard of liability for breaches of the duty of care. Just as shareholders began more aggressively to use the derivative suit to voice their objections to certain corporate decisions and actions, the courts (specifically New York courts) restated the business judgment rule, traditionally a rule recognizing human fallibility, as a rule of absolute deference to experts. As such, it rapidly became a means of restraining shareholders' ability to tame corporate directors and managers, even if the actions of the latter harmed the corporation.[7] The rhetoric of democracy and representation became increasingly apologetic.

Beginning in the 1960s, the focal point for analysis shifted to the market. As the fourth part of this article explains, mainstream legal scholars and economists came to believe that the market was the most effective institution to constrain corporate (and political) activities. In addition to the fears of corpo-

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5. Unless otherwise stated, the term management in this article refers to the corporation's top executives.

6. The period from the 1930s through the 1970s is typically referred to as the managerial period due to the fact that, for different reasons, management dominated the composition of boards and non-management directors played a minimal role, if any, in the corporations on whose boards they served. The idea that directors were representatives of the shareholders prevailed during this period.

7. While it might be surprising, the development of the business judgment rule as we know it today took place only in the last decades of the twentieth century. *See* discussion *infra* Sections III.C and IV.D.

rate power, which faded after influencing the debates in the early twentieth century, the concerns about corporate hierarchies that dominated the mid century discussions disappeared. Just as insider professional management became more powerful and the board of directors became ever less involved in managing the affairs of the corporation,[8] scholars returned to the rhetoric of the laws of contracts and agency to describe directors as the (private) agents of the shareholders. This description worked in tandem with a particular model of the board that emerged in the 1970s—the monitoring board, composed of a majority of independent or outside directors.[9] The presence of independent directors substantiated the description of directors as the shareholders' agents, while the insiders were left to act almost with no constraints or liabilities.

The Delaware courts, which by the last decades of the twentieth century had become the authoritative voice of U.S. corporate law, endorsed the portrayal of directors as agents (albeit with modifications) and of the board's role as monitoring. As if to complement the limited status and role they assigned to the board, the Delaware courts also collapsed the duty of care into the business judgment rule and restated the rule, proclaiming that it altered the standard of care applicable to directors' actions from negligence to gross negligence. The rule that originated in the recognition of human imperfections, and later became a rule of deference to experts, was transformed into a shield against liability. If there was ever a possibility of imposing liability on directors for breaches of

8. *See, e.g.*, Lewis D. Solomon, *Restructuring the Corporate Board of Directors: Fond Hope—Faint Promise?* 76 MICH. L. REV. 581, 581 (1978) (noting that "management has minimized the board's participation in corporate governance, and the board of directors has been reduced to an 'impotent ceremonial and legal fiction.'").

9. The monitoring board's tasks were limited. It was to select, oversee, and, when necessary, fire the corporation's CEO, to ensure "the general integrity of the operation," and to make certain fundamental decisions. *See* Lawrence E. Mitchell, *The Trouble with Boards*, *in* THE NEW CORPORATE GOVERNANCE, Troy A. Paredes, ed. (forthcoming) (manuscript at 26-27, *available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=801308*) (describing the emergence of the monitoring board). *See also* Jeffrey N. Gordon, *The Rise of Independent Directors in the United States, 1950-2005: Of Shareholder Value and Stock Market Prices*, 59 STAN. L. REV. 1465 (2007) (describing the correlation between the rise of independent directors, whose role is to monitor management, and the maximization of shareholder value).

their duty of care, that possibility was almost nonexistent by the end of the 1980s. As the epilogue concludes, directors' liability at the turn of the twenty-first century seems to be, if anything, an ideal with no practical effect.

I. SETTING THE STAGE: THE BOARD OF DIRECTORS AT CENTURY'S END

A. *Changing Roles*

Boards of directors have been part of the corporate structure at least for several centuries. Early charters, such as the 1791 Charter of the Bank of the United States, provided for boards of directors to be elected by the shareholders. In 1811, New York enacted the first American general incorporation statute, providing that "the stock, property and concerns of such company shall be managed and conducted by trustees, who, except those for the first year, shall be elected at such time and place as shall be directed by the by laws of the said company." [10] But, while the board existed, it was not considered to be a significant body in the early nineteenth century and it received little, if any, attention from jurists.

This token attention fit the minimal role directors were expected to play in their corporations. Typically, those who owned all or a majority of a corporation's stock managed the corporation. Directors, if different from the owners, served "for the prestige associated with the position."[11] Directors were expected to exercise due care and diligence in managing the affairs of the corporation (although the required standard of care was continuously debated).[12] But, for the most part, the role of the board was symbolic; directors were typically described as "gratuitous mandatories." As some historians sug-

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10. Gevurtz, *supra* note 1, at 108. *See also* Robert A. Kessler, *The Statutory Requirement of A Board of Directors: A Corporate Anachronism*, 27 U. CHI. L. REV. 696, 703 (1960) ("It must be conceded that boards of directors, or 'assistants' and 'committeemen' as they were originally called, have long existed as part of the structure of corporations.").

11. Stephen J. Lubben & Alana J. Darnell, *Delaware's Duty of Care*, 31 DEL. J. CORP. L. 589, 595 (2006).

12. Marcia M. McMurray, *An Historical Perspective on the Duty of Care, the Duty of Loyalty, and the Business Judgment Rule*, 40 VAND. L. REV. 605, 606-07 (1987).

gest, the board was, perhaps, a reflection of the republican nature of American political institutions.[13]

Indeed, while the directors' role might have been symbolic, the appropriate allocation of power between directors and executives was a contested issue. State charters of incorporation attempted to devise internal governance structures that "mirrored republican institutions so as to prevent the rise of overpowering corporate executive authority."[14] Seeking to "blur the distinction between the board of directors elected by the stockholders, and the highest executive officials (or managers)" these state charters often required the board to appoint one of the directors as the corporation's president.[15]

By mid nineteenth century, attempts to control corporate internal structures proved to be inefficient as conflicts between "technical and financial managers" became abundant (especially in the railroad industry). Those who had the financial means to be elected to boards were typically unfamiliar with the management of the business or had little time to engage in it. Legislatively imposed checks and balances rapidly disappeared; as one historian put it, "paramount executive authority had emerged despite organizational restrictions."[16]

Interestingly, it was in this context that jurists turned their attention to the board of directors. Take, for example, the key corporate law treatises of the nineteenth century. In 1831, Joseph Angell and Samuel Ames saw no need to address the board of directors in their famous *Treatise on the Law of Private Corporations Aggregate.* Almost fifty years later, in 1880, Judge Seymour Thompson devoted two of six chapters in his treatise,

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13. On the republican origin of the modern corporation, see Pauline Maier, *The Revolutionary Origins of the American Corporation*, 50 WM. AND MARY Q. 51 (1993); Liam S. O'Melinn, *Neither Contract nor Concession: The Public Personality of the Corporation*, 74 GEO. WASH. L. REV. 201 (2006). It is also important to remember that with the exception of railroads and banks, the shares of which were publicly traded, "the nineteenth century was a time of control through restrictive charters and detailed statutes dealing with corporate and board powers in the context of a population of overwhelmingly closely-held corporations." Lawrence E. Mitchell, *Introduction*, CORPORATE GOVERNANCE (Ashgate, forthcoming 2008).

14. James A. Ward, *Power and Accountability on the Pennsylvania Railroad, 1846-1878*, 49 BUS. HIST. REV. 37, 38 (1975).

15. *Id.*

16. *Id.* at 58. *See generally* ALFRED D. CHANDLER JR., THE VISIBLE HAND: THE MANAGERIAL REVOLUTION IN AMERICAN BUSINESS (1977).

The Liability of Directors and Other Officers and Agents of the Corporation, to the liability of directors.[17]

This interest in the directors' role reached beyond academic literature. Amidst unfolding corporate scandals and growing concerns about corporations' liabilities for their workers, consumers, and capital providers, public opinion raised significant questions about the role of the board, including:

> [W]hether the directors of a modern business corporation do in any proper sense direct, whether and how far the directors are personally liable when the affairs of the corporation are grossly mismanaged, and what duties if any, the directors owe to the public, to the stockholders, and to the creditors of the corporation.[18]

The first publicly held corporations in the United States were banks and insurance companies (and later, railroads), hence the first judicial analyses of these questions involved financial institutions.[19] As the following section explains, while it was settled that directors owed a duty of care to their corporations, the standard by which their actions were judged was widely debated. At least in part, courts' definitions of directors' standard of liability reflected their understanding of the appropriate relationship between the different corporate constituencies, specifically, the relationship between directors and officers.

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17. JOSEPH K. ANGELL & SAMUEL AMES, A TREATISE ON THE LAW OF PRIVATE CORPORATIONS AGGREGATE (1831); SEYMOUR D. THOMPSON, THE LIABILITY OF DIRECTORS AND OTHER OFFICERS AND AGENTS OF CORPORATIONS (1880). *See also* MORTON J. HORWITZ, THE TRANSFORMATION OF AMERICAN LAW, 1870-1960: THE CRISIS OF LEGAL ORTHODOXY, 98-100 (1992) (describing this transformation).

18. Charles F. Beach, Jr., *The Functions and Accountability of Railway Directors*, THE INDEPENDENT, Sept. 3, 1891, at 4, *available at* APS Online.

19. *See similarly* Henry Ridgely Horsey, *The Duty of Care Component of the Delaware Business Judgment Rule*, 19 DEL. J. CORP. L. 971, 973-74 (1994) ("In this country, by the nineteenth century, the concept that corporate directors owed a common law fiduciary duty of care to their institutions was recognized but was generally confined to the directors of banks and financial institutions.").

B. *Allocating Liability*

Some cases were relatively easy. All courts held directors liable in cases involving fraud or bad faith, intentional violations of positive law, or complete passivity in the face of suspected improper conduct by officers. In a similar manner, directors were exempt from liability for honest mistakes, also known as mistakes that even a prudent person might make. (Such an exemption existed throughout the nineteenth century and, as I will elaborate in the third part of this article, became the foundation for the modern business judgment rule.[20]) Jurisdictions (and courts) differed, however, in assessing situations in which the directors, due to other demands on their time (including active roles in their own businesses), were simply inattentive, and situations in which the directors, after exercising judgment in selecting employees, did not monitor their actions. As one writer summarized the courts' positions on the matter: "If a director is guilty of fraud, or of violating a statute, or of executing his authority, he is clearly liable. Beyond this he may be liable for something more, but precisely what cannot be told until the matter comes before the court for determination.[21]

Take, for example, *Spering's Appeal*, a case that involved an action by the assignee of the National Safety Insurance and

20. Perhaps the earliest articulation of this exemption was found in Percy & Al. v. Millaudon & Al., 8 MART. (n.s.) 68, 77-78 (La. 1829) ("[T]he adoption of a course from which loss ensues cannot make the [director] responsible, if the error was one into which a prudent man might have fallen. . . . The test of responsibility therefore, should be, not the certainty of wisdom in others, but the possession of ordinary knowledge and by showing that the error of the [director] is of so gross a kind that a man of common sense, and ordinary attention, would not have fallen into it."). *See also* Godbold v. Branch Bank at Mobile, 11 ALA. 191, 199 (1847) (explaining that directors do not "undertake that they possess such a perfect knowledge of the matters and subjects which may come under their cognizance, that they can not err, or [sic] mistaken, either in the wisdom or legality of the means employed by them"); Hodges v. New England Screw Co., 3 R.I. 9, 18 (1853) ("[A] Board of Directors acting in good faith and with reasonable care and diligence, who nevertheless fall into a mistake, either as to law or fact, are not liable for the consequences of such mistake"); S. Samuel Arsht, *The Business Judgment Rule Revisited*, 8 HOFSTRA L. REV. 93, 99-100 (1980) (arguing that "the principal genesis of the business judgment rule" was "human fallibility.").

21. Albert S. Bolles, *The Duty and Liability of Bank Directors*, 12 YALE L.J. 287, 299 (1903).

Trust Company against its directors for, among other things, improper management of its affairs as evidenced by imprudent investment decisions that left the company bankrupt. Informed by the early-nineteenth century tradition of labeling directors "gratuitous mandatories," the Supreme Court of Pennsylvania described the company's directors as "persons who have gratuitously undertaken to perform certain duties, and who are therefore bound to apply ordinary skill and diligence, but no more." [22] Noting that directors were typically shareholders, the court concluded: "it is evident that gentlemen elected by the stockholders from their own body ought not to be judged by the same strict standard as the agent or trustee of a private estate. Were such a rule applied, no gentlemen of character and responsibility would be found willing to accept such places."[23] Hence, the court held that the directors were not liable "for mistakes of judgment, even though they may be so gross as to appear to us absurd and ridiculous, provided they are honest and provided they are fairly within the scope of the powers and discretion confided to the management body."[24] In short, according to the Supreme Court of Pennsylvania, in exercising their powers, directors were only required to avoid gross negligence. [25]

The Court of Appeals of New York adopted a different approach less than a decade later. In *Hun v. Cary*, an action by the receiver of the Central Savings Bank of the City of New York against the bank's trustees for making bad investment decisions, the court held the directors to a higher degree of care, that is, "the degree of care that an ordinarily prudent person would exercise in conducting personal business affairs."[26] Judge Earl stressed that the standard was "not the highest degree, not such as a very vigilant or extremely careful person would exercise" because, as he reasoned, "if such were required, it would be difficult to find trustees who would incur the responsibility of such trust positions."[27] Yet he also found the lowest degree of care inappropriate. "Few persons would be willing to deposit money in savings banks, or to take stock

22. Spering's Appeal, 71 Pa. 11, 17, 21 (1872).
23. *Id.* at 21.
24. *Id.* at 24.
25. *See* McMurray, *supra* note 12, at 607 & n.11.
26. *Id.* at 607 & n.13
27. Hun v. Cary, 82 N.Y. 65, 70-71 (1880).

in corporations," Earl reasoned, "with the understanding that the trustees or directors were bound only to exercise slight care, such as inattentive persons would give to their own business, in the management of the large and important interests committed to their hands." [28] Finding a mean between the highest degree of care and the lowest one, Judge Earl concluded that "when one deposits money in savings bank, or takes stock in a corporation. . . he expects, and has a right to expect, that the trustees or directors, who are chosen to take his place in the management and control of his property, will exercise ordinary care and prudence in the trusts committed to them—the same degree of care and prudence that men prompted by self-interest generally exercise in their own affairs."[29]

While the holdings in these cases and others turned ultimately on their facts, the conceptual differences between the Pennsylvania and New York approaches were significant. Judge Sharswood, who wrote the decision in *Spering's Appeal*, was almost exclusively concerned about imposing too demanding a standard of liability on directors lest no gentleman would accept their position.[30] In comparison, Judge Earl, who wrote the decision in *Hun*, focused on the appearance of public duty, treating directors as public officials. Accordingly, a director "who undertakes to act for another in a situation or employment requiring skill and knowledge" must discharge his duties with ordinary care; "and it matters not that the service is to be rendered gratuitously."[31]

In other words, the Pennsylvania courts viewed the question within the narrow lens of corporate law, a matter involving no one but private parties. Accordingly, the issue was the

28. *Id.* at 71.
29. *Id.*
30. *See similarly* Bolles, *supra* note 71, at 289-90 ("[The] minimum liability rule regards the matter from the director's side. He is indeed required to exercise a general supervision, and fulfill a few specific statutory requirements, but not much more. It is not expected that he will devote much time to the affairs of the bank, as he is rarely paid anything for his service, and generally is engaged in other and far more important business. It is not reasonable to expect that he will examine the books and other records, and without doing these things he cannot know much about the details of the bank's affairs; and this is supposed to be known by all who do business with banking institutions.").
31. *Hun*, 82 N.Y. at 74.

allocation of liability and blame as between directors and executives with a nod to the fact that shareholders elected their directors. For the New York courts, the matter reached beyond the private parties involved to pressing questions of governance in modern industrialized society. While the Pennsylvania courts legitimated the status quo, that is, the expanding power of executive officers and the diminishing role of directors, the New York courts, fearing potential abuses of executive power, insisted on finding a role for the board.

The U.S. Supreme Court was similarly conflicted. In 1891, in *Briggs v. Spaulding*, the Court assessed an action by a shareholder against the directors of a bank for losses incurred as a result of the unsupervised activities of the bank's president. One member of the board of directors was "an elderly man of great experience in banking, [who] regarded himself as merely an adviser, [and who] remained upon his farm at a distance during the time of wrong-going and did not go near the bank, relying wholly upon the new President's statement that everything was going well." Another director was "crippled with rheumatism" and "unable to attend to the bank's affairs," while a third director "had illness in his family and remained away" during the period of wrongdoing.[32]

Writing for five justices, Chief Justice Fuller emphasized that the degree of care required of directors is "that which ordinarily prudent and diligent men would exercise under similar circumstances."[33] But, he added, "what may be negligence in one case may not be want of ordinary care in another, and the question of negligence is, therefore, ultimately a question of fact, to be determined under all the circumstances."[34] In this particular case, and despite the apparent neglect by the directors, the majority held that the directors were not liable. As Fuller put it, given the structure of the public corporation, directors could rely on their corporation's agents to manage the corporation as long as they were not grossly negligent in doing so.[35]

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32. Frederick Dwight, *Liability of Corporate Directors*, 17 YALE L.J. 33, 37-38 (1907).

33. Briggs v. Spaulding, 141 U.S. 132, 152 (1891).

34. *Id.*

35. *Id.* at 147-48.

Justice Harlan, joined by three other justices, wrote a harsh dissent. He thought it implausible to assume that directors of a national bank, entrusted with managing the bank "diligently and honestly," could "abdicate their functions and leave its management and the administration of its affairs entirely to executive officers."[36] Harlan agreed that the directors could authorize officers or agents to act "in respect to matters of current business and detail that may be properly entrusted to them by the directors."[37] But, as he pointedly put it:

> [C]ertainly, Congress never contemplated that the duty of directors to manage and to administer the affairs of a national bank should be in abeyance altogether during any period that particular officers and agents of the association are authorized or permitted by the directors to have full control of its affairs. If the directors of a national bank choose to invest its officers or agents with such control, what the latter do may bind the bank as between it and those dealing with such officers and agents. But the duty remains, as between the directors and those who are interested in the bank, to exercise proper diligence and supervision in respect to what may be done by its officers and agents.[38]

Harlan stressed that the appropriate standard demanded that the directors exercise "diligence and supervision as the situation and the nature of the business requires. . . they must do all that reasonably prudent and careful men ought to do for the protection of the interests of others entrusted to their charge."[39]

When compared word-for-word, the differences between the standards articulated by the *Briggs* majority and dissent seem almost insignificant. Like the New York and Pennsylvania cases, the conflicting rulings reflected, in part, the justices' attempts to grasp the changing role of the board of directors in light of the structural changes occurring in American corporations. Yet, as I argue in the following section, debates about

36. *Id.* at 169 (Harlan, J., dissenting).
37. *Id.*
38. *Id.* Harlan's mention of Congress is in reference to the National Bank Act.
39. *Id.* at 170.

the standard of negligence applicable to corporate directors had perhaps less to do with corporate law *per se* than with the unsettled state of the law of negligence. In this vein, debates about the appropriate role of the board of directors reflected the jurisprudential crisis of the late nineteenth century.

C. *Negligence*

The question whether there were different "degrees of negligence" was widely debated in the late nineteenth century. In 1703, British Chief Justice Holt had classified negligence into three categories: gross, ordinary, and slight. Beginning in the mid nineteenth century, however, with the emergence of classical jurisprudence and the advance of the scientific method, legal writers became concerned that such categories could undermine law's (proclaimed) objectivity. A conception of slight negligence raised concerns about imposing strict liability on certain actors (particularly the railroads). In turn, the concept of gross negligence was seen as a means of giving too much discretion to juries who could engage in "moralistic and subjective" assessments of the behavior in question. As Morton Horwitz explains:

> [T]he three-tier conception of negligence and the doctrine of punitive damages cut against the efforts of late-nineteenth-century legal thinkers to develop a clear boundary between an apolitical, anti-redistributive private law and an inherently unstable, political public law. If the functions of tort and criminal or regulatory law were overlapping—if the tort law could legitimately move beyond the realm of corrective justice into that of punishment for immoral behavior—the idea of an apolitical private law whose sole function was to vindicate private rights was threatened.[40]

Seeking to eliminate moralism and subjective standards from the science of law, and promote instead "order, uniformity, certainty, and predictability," liberal legal thinkers argued

40. HORWITZ, *supra* note 17, at 115. Concerns about imposing strict liability on railroads stemmed from broader concerns about encouraging risk-taking, which by the late nineteenth century was seen as a prerequisite for economic development. MORTON J. HORWITZ, THE TRANSFORMATION OF AMERICAN LAW, 1780-1860 (1977).

that in fact there was only one standard for determining negligence, that of the "ordinary and prudent man."[41]

Similar concerns underlay the courts' assessments of directors' duties and liabilities. For example, Chief Justice Fuller began his analysis in *Briggs* by stressing that judicial opinion was "adverse to the distinction between gross and ordinary negligence."[42] Citing Justice Bradley in *Railroad Co. v. Lockwood,* a case involving a suit to recover damages for injury suffered by the plaintiff while traveling on the defendant company's train, Fuller noted that the different categories of negligence were

> indicative rather of the degree of care and diligence which is due from a party and which he fails to perform, than of the amount of inattention, carelessness or stupidity which he exhibits. If very little care is due from him, and he fails to bestow that little, it is called gross negligence. If very great care is due, and he fails to come up to the mark required, it is called slight negligence. And if ordinary care is due, such as a prudent man would exercise in his own affairs, failure to bestow that amount of care is called ordinary negligence. In each case the negligence, whatever epithet we give it, is failure to bestow the care and skill which the situation demands; and hence it is more strictly accurate, perhaps, to call it simply "negligence."[43]

Given this growing tendency to abandon the three-tier approach to negligence, it is not surprising that some commentators argued that the Pennsylvania and New York approaches were governed not by different rules but, in fact, by the same rule that "directors in any corporation must devote the amount of care to the business which ordinary men would give under the circumstances."[44] In other words, the required degree of care was not merely to avoid gross negligence, nor was it the degree of care that a prudent individual would exercise

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41. HORWITZ, *supra* note 17, at 115-16.

42. *Briggs,* 141 U.S. at 151 (quoting Railroad Co. v. Lockwood, 17 WALL 357, 382 (1873)).

43. *Id.* at 151-52 (quoting Railroad Co. v. Lockwood, 17 WALL 357, 382 (1873)).

44. Note, *Liability of Corporation Directors for Negligence,* 19 HARV. L. REV. 613, 613 (1906).

in conducting his business affairs, but rather an intermediate standard of the degree of care that a prudent person would exercise in similar circumstances.

Another means by which late nineteenth century thinkers mediated the tensions between moralism and coercion was custom, a concept that reflected the promise of social harmony without the need for legal and social coercion.[45] Some courts thus held that directors were required to exercise the diligence that is customary in their industry: "Not the ordinary care which a man takes of his own business, but the ordinary care of a bank director in the business of a bank. Negligence is the want of care according to the circumstances, and the circumstances are everything considering the question."[46] In a similar manner, one author attempted to reconcile the Pennsylvania and New York approaches by pointing out that *Hun* involved the actions of directors of a savings bank, engaged in solicitation of business from "small depositors who are seeking safety for their earnings rather than a high rate of interest." The court was thus correct in imposing on directors of such an institution a stricter duty than that which applied to the directors of the "for-profit corporation" involved in *Spering's Appeal*.[47]

By the early twentieth century, most legal commentators, whether they endorsed the standard of the ordinary self-interested individual, the ordinary individual in similar circumstances, the ordinary director, or the ordinary director in any given industry, criticized those who exempted directors from liability unless they were grossly negligent. [48] Reflecting the prevailing sentiment, Frederick Dwight wrote:

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45. HORWITZ, *supra* note 17, at 122-23.

46. Bolles, *supra* note 21, at 290-91 (quoting Chief Justice Paxson in Swentzel v. Penn Bank, 23 A. 405, 414 (Pa. 1892)). *See also* M.C. Lynch, *Diligence of Directors in the Management of Corporations*, 3 CAL. L. REV. 21, 29 (1914) (noting that it might be "advisable to divide corporations into several classes for this purpose . . . Such a classification might be as follows: (a) ordinary manufacturing, mining, or trading corporations; (b) monied corporations, as banks or insurance companies; (c) public service corporations; (d) charitable, educational, or religious corporations.").

47. Note, *supra* note 44.

48. *See similarly* Horsey, *supra* note 19, at 974 ("By the early part of [the twentieth] century, courts across the country accepted the proposition that officers and directors of industrial concerns, as well as banks, and their majority shareholders stood in a fiduciary relationship to their corporation and

> Where else in human affairs may be found so admirable a combination of distinction without anxiety, of reward without toil? Would it not be well for the corporations and society at large if penalties that are admitted to be proper in the abstract were insisted upon until the prodigious number of pseudo-directors who are now in evidence *were* "squeezed out," and a really hard-working director, as distinguished from an officer, became less of an anomaly than he seems under present conditions?[49]

Woodrow Wilson was even more pointed. Calling for a higher standard of liability, he noted that without it any attempt to impose liability on directors was like "a game of hide and seek, with the objects of [the] search taking refuge now behind the tree of their individual personality, now behind that of their corporate irresponsibility."[50]

Moreover, by the 1910s, both Delaware and New Jersey, informed by New York's approach, found directors liable when their actions deviated from those of the reasonable director. [51] By that time, even the Pennsylvania courts rejected the *Spering's Appeal* approach and moved closer to the *Hun* court's position. [52]

The rhetoric of ordinary negligence remained viable through most of the twentieth century. But the meaning of ordinary negligence changed as each generation of jurists offered a different description of the directors' status, ultimately returning to the standard of gross negligence. I begin, in the following section, with the Progressives. They rejected the

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to their minority shareholders. Courts recognized that directors, as quasi-trustees, should be judged by fiduciary standards of not simply good faith but prudent conduct.").

49. Dwight, *supra* note 32, at 42. *See also* Lynch, *supra* note 46, at 25 ("The doctrine that directors should be liable for gross negligence only does not seem to receive sympathetic support in the popular mind nor in the general declarations of the courts.").

50. WOODROW WILSON, THE NEW FREEDOM A CALL FOR THE EMANCIPATION OF THE GENEROUS ENERGIES OF A PEOPLE 11-12 (1913), *cited in* Lynch, *supra* note 46, at 41.

51. Lubben & Darnell, *supra* note 11, at 596-97.

52. McMurray, *supra* note 12, at 607 n.13, 610 and cases cited therein. *See also* C. Brewster Rhoads, *Personal Liability of Directors for Corporate Mismanagement*, 65 U. PA. L. REV. 128 (1916) (discussing the transformation in the Pennsylvania courts).

classical legal thinkers' description of directors as agents and instead proclaimed directors to be trustees subject to heightened duties. As the second part of this article will explore, in the 1930s these ideas were cemented into corporate law albeit for a very short time.

D. *From Agents to Trustees*

Throughout the nineteenth century directors were described as both agents and trustees.[53] Yet courts and commentators seemed to agree that while the directors' role was similar to that of agents and trustees, these labels were not entirely accurate when applied to directors.[54] By the end of the nineteenth century, however, amidst a vital transformation of American legal thought, each label had become ideologically charged.

Take, for example, the majority opinion in *Briggs*. As Chief Justice Fuller's rhetorical critique of the different categories of negligence indicated, his decision was deeply grounded in late nineteenth century classical legal thought; it rested on the assumption that the role of law was to demarcate the appropriate boundaries between a private sphere of individual freedom and a public sphere of state (coercive) power. The governance of the modern corporation was a private matter to be determined by those affected by it, that is, the shareholders.[55] In this vein, for Fuller, directors' duties were the duties of private agents. [56]

The description of directors as agents and their liability as derived from the law of agency fit the contractual vision of corporate entities, which classical legal thinkers endorsed. Accordingly, corporations were associations of individuals, not very different from partnerships; these individuals, the shareholders, elected directors as agents to manage their property. Proponents of the agency theory went so far as to suggest that the shareholders were to share in the blame for directorial

53. *Liability of Directors of Corporations*, 6 S.L. Rev.n.s. 385, 387 (1880-81).

54. McMurray, *supra* note 12, at 605-06 and cites therein.

55. *See similarly* R. Jeffrey Lustig, Corporate Liberalism: The Origins of Modern American Political Theory, 1890-1920, 92 (1982) (discussing Fuller's decisions in the *Slaughter House* and *Munn* cases).

56. *Briggs*, 141 U.S. at 147.

mismanagement because they were negligent in selecting their agents.[57]

But the contractual paradigm could not accommodate the dramatic changes in business structure at the turn of the twentieth century. While antebellum businesses typically were single-unit enterprises owned by small groups of investors, businesses were becoming multi-unit enterprises in the late nineteenth century. As maximizing output from the new economies of scale required large capital investments, which most individuals lacked, firms began to draw capital from widely dispersed individuals. The contractual paradigm, which represented the corporation as the aggregated property of its shareholders, seemed to ignore the recognized truth that ownership in large public corporations was rapidly separating from control; in other words, "individual corporators were responsible neither for much of the growth within a given corporation nor for the adverse consequences of corporate actions."[58]

The classical liberal approach of identifying directors as agents and applying traditional agency law to the modern public corporation also raised serious doctrinal problems. If shareholders were principals, then unanimous shareholder consent was the corporation's ultimate authority. Such an understanding stood in direct contradiction both to the increasing passivity of shareholders and to the growing legislative and judicial acceptance, in the late nineteenth century, of majority shareholder voting to approve charter amendments and fundamental transactions. Moreover, if directors were agents, agency law prohibited them from delegating their powers, thus prevent-

57. Keith F. Warren, *Looking Back: Selections from the Banking, Financial and Economic Thought of the Past Which Apply to Today's Problems*, BANKERS' MAGAZINE 1896, Oct. 1941, at 330, *available at* APS Online (quoting from October 1891: "whenever a bank has been unfortunate in the selection of directors are the stockholders wholly relieved from liability themselves? For, how came the directors to occupy their positions—were they not the choice of the stockholders? And thus we see at last that the management of a bank falls on them; the directors and managers are only their agents selected to do their bidding. While they ought not to escape if they have neglected their duties, neither ought the stockholders to be permitted to throw the blame which, after all, must rest on themselves.").

58. Gregory A. Mark, Comment, *The Personification of the Business Corporation in American Law*, 54 U. CHI. L. REV. 1441, 1464-65 (1987).

ing them from empowering the corporation's executives. This directly conflicted with corporate practice. [59]

Not surprisingly, by the early twentieth century, the view that directors were agents of the shareholders came under attack, and with it the entire worldview espoused by classical legal thinkers. Justice Harlan's dissent in *Briggs* anticipated the Progressives' critique of classical legal thought.

Beginning with Oliver Wendell Holmes Jr. in the late nineteenth century, Progressive legal thinkers described the classicist vision as obscuring the inherently political nature of law. They (and the legal realists who followed them in the 1920s and 1930s) argued that, by employing the public-private distinction and thus treating the market as natural and neutral, classical legal thought had obscured the role of the state in distributing wealth and power, and particularly in strengthening the position of business corporations. Progressives and legal realists rejected the distinction between a supposedly non-coercive private sphere of individual rights and a coercive public sphere of state regulation as fundamentally misguided because all relations among private parties were premised on the existence and enforcement of the law of contracts and property by the state. Private law was thus a form of coercive public law.[60]

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59. *See similarly* Rudolph E. Uhlman, *The Legal Status of Corporate Directors*, 19 B.U.L. REV. 12, 12-13 (1939) ("It needs no labored argument to show that the doctrine which likens corporate directors to agents is not supported by the law of agency, for an agent's authority is derived from his principal, and may also be revoked by him, while the powers of corporate directors do not emanate from the corporate entity and are ordinarily not subject to revocation"); Gerald E. Frug, *The Ideology of Bureaucracy in American Law*, 97 HARV. L. REV. 1277, 1306 (1984) (noting that the statutory allocation of the power to manage the corporation to the board of directors undercuts the idea that shareholders voluntarily delegate power to the board); Deborah A. DeMott, *Disloyal Agents*, 58 ALA. L. REV. 1049, 1051-52 (2007) (noting that "within U.S. corporate law, a corporation's shareholders do not have a relationship of common law agency with the corporation's directors. To be sure, directors owe fiduciary duties to the corporation and its shareholders, but directors, once elected, hold powers of management that are not delegated powers comparable to a common law agent's authority.").

60. On Progressive legal thought and legal realism, see HORWITZ, *supra* note 17; Dalia Tsuk, *Legal Realism*, *in* LEGAL SYSTEMS OF THE WORLD: A POLITICAL, SOCIAL, AND CULTURAL ENCYCLOPEDIA 892, 893 (Herbert M. Kritzer ed., 2000).

As if foreseeing the later Progressives' critique, and in contrast to Fuller's description of directors as private agents, Justice Harlan described corporations as public entities and analogized the directors' position to that of public officials. Accordingly, directors held honorable public positions and, with them, accompanying public duties.

Indeed, Progressive legal scholars insisted that the board of directors was created by the state, not by the shareholders. The board's power was thus original and undelegated. [61] The power of the corporation was the power of the board.[62] With this in mind, most legal scholars also described directors as trustees of their corporations and "consequently. . . burdened with the duty of diligently and faithfully discharging" the duties imposed on them "by the laws of the corporation and the State." If no "specific statutory prescription" existed, directors were "bound to exercise such care as the nature of [their] supervision requires." [63]

Viewing the board's power as original and undelegated was consistent with the real entity theory of the corporation favored by Progressives. At the turn of the twentieth century, the real entity theory competed with the contractual theory to describe the modern public corporation. The real entity theory developed out of natural entity theory. Natural entity theory described corporations as separate entities, distinct from their individual members and having real existence, with rights and liabilities similar to those of persons (specifically, constitutional rights and criminal and tort liabilities). Progressive legal thinkers, who did not accept the personification of the corporation (especially the idea that corporations, like in-

61. *See* I. Maurice Wormser, *Directors—Or Figures of Earth?*, 1 BROOK L. REV. 28, 28 (1932) ("The powers of the board of directors are derivative only in the sense of being received from the sovereign in the charter of incorporation.").

62. HORWITZ, *supra* note 17, at 99-100. *See also* David Millon, *Theories of the Corporation*, 1990 DUKE L.J. 201, 215 (noting the difference between the "traditional principles [which] vested ultimate managerial power in the shareholders, with directors enjoying only such responsibility as actually was delegated" and the early-twentieth century "legal doctrine" which "came to locate managerial power in the directors as a matter of law, regardless of any express delegation . . . [and] the directors' powers . . . [as] . . . coextensive with those of the corporation itself.").

63. P. B. McKenzie, *Liability of Directors Who Do Not Direct*, 18 BENCH & B. o.s. 100 (1909); *see also* Rhoads, *supra* note 52, at 139-44.

dividuals, should have constitutional rights), nonetheless saw corporate existence as real and not merely as a contractual arrangement. They employed the real entity theory pragmatically—it offered an accurate description of corporate reality, with its multiplicity of ownership, complex financial structure, managerial control, immortality, and, most important, power.[64] It is with this vision that the twentieth century conversations about the status, role, and liability of the board of directors began.

As the second part of this article explores, concerns about corporate power led scholars to develop a particular vision of the corporation's role in society. Viewing corporations as real entities and equating board power with corporate power were aspects of this vision. While late nineteenth century discussions centered on the allocation of liability between directors and executives, the early-twentieth century's concerns were focused on the role of directors in taming the growing power of the control group, be it controlling shareholders or management. As Progressive legal thought came to dominate American legal discourse in the early 1930s, so did the vision of directors as trustees for the corporation, its shareholders (specifically its minority shareholders), and the community. The notion that directors were agents of their shareholders disappeared, at least for a while. It forcefully returned at the end of the twentieth century.

II.
1900s-1930s: Directors as Trustees

A. *Corporate Power*

The turn of the twentieth century witnessed a dramatic growth in the scale of private business organizations. Increasing consumer demand, rising numbers of skilled and unskilled workers, and an expanding pool of capital made the creation

64. Dalia Tsuk, *Corporations without Labor: The Politics of Progressive Corporate Law*, 151 U. Pa. L. Rev. 1861, 1870-73 (2003) and cites therein. The best contemporaneous summary of the debates about the nature of corporations and other associations remains John Dewey, *The Historic Background of Corporate Legal Personality*, 35 Yale L.J. 655-73 (1926). For recent discussions, see Mark M. Hager, *Bodies Politic: The Progressive History of Organizational 'Real Entity' Theory*, 50 U. Pitt. L. Rev. 575 (1989); Mark, *supra* note 58; Millon, *supra* note 62.

of large enterprises possible, while corporate lawyers created a variety of legal devices to help their clients increase the scope of their operations through "cooperation and combinations."[65] Trusts, holding companies, and mergers became common, even if often contested in state courts.[66] The nineteenth-century corporation, which was subject to strict constraints on its powers as well as limitations on its capital structure, was replaced by larger and larger units. Between 1888 and 1896, New Jersey revised its general incorporation statute to eliminate restrictions on "capitalization and assets, mergers and consolidations, the issuance of voting stock, the purpose(s) of incorporation, and the duration and locale of business."[67] Other states (including Delaware, which would soon become the revolution's leader) followed suit, enacting incorporation statutes that were more enabling than mandatory. [68] And corporations were quick to use the power that these enabling statutes granted them. Between 1898 and 1901, "2,274 firms disappeared as a result of merger, and merger capitalization totaled $5.4 billion."[69]

The concentration of power in the trusts and large business corporations undermined traditional understandings of economic and political markets. Progressives worried that corporations were wearing away the function of the individual producer and, with it, nineteenth-century democratic and economic ideals. These ideals were the power of markets equally to "distribute the rewards of individual industry" and to help

65. AMERICAN LEGAL REALISM 130 (William W. Fisher, III, Morton J. Horwitz & Thomas A. Reed eds., 1993).

66. *See id.* at 131 (tracing the development of corporate ownership structures and corresponding government regulations); *see also* ROLAND MARCHAND, CREATING THE CORPORATE SOUL: THE RISE OF PUBLIC RELATIONS AND CORPORATE IMAGERY IN AMERICAN BIG BUSINESS 7 (1998) (noting the proliferation of corporate mergers between 1895 and 1904).

67. SCOTT R. BOWMAN, THE MODERN CORPORATION AND AMERICAN POLITICAL THOUGHT: LAW, POWER, AND IDEOLOGY 60 (1996).

68. *Id.*

69. Melvin I. Urofsky, *Proposed Federal Incorporation in the Progressive Era*, 26 AM. J. LEGAL HIST. 160, 161 (1982). It is important to note that the term "merger" is misleading as many of these transactions were sales of assets for stock. LAWRENCE E. MITCHELL, THE SPECULATION ECONOMY: HOW FINANCE TRIUMPHED OVER INDUSTRY 292-93 n.33 (2007).

"conform individual liberty" to socially beneficial ends.[70] Progressives were concerned that giant corporations obfuscated "the traditional relationships between individual liberty, competition and social utility."[71] They therefore emphasized the need to control and restrain corporate power.

Some reformers emphasized the need to control business units locally in order to encourage civic participation and to keep corporate power in check. Others wanted to subject large corporations to national regulation.[72] Interestingly, while endorsing two presumably opposing positions—decentralization and centralization of power, respectively—both groups of scholars and policymakers chose mandatory disclosure as the ultimate means of regulating corporate power.[73]

Given the scope of the problem of corporate power, and the attempt nationally to use mandatory disclosure to regulate it, courts did not systematically address the matter. Moreover, by the early 1930s, courts were typically more concerned about protecting corporations from potential bankruptcy proceedings than taming their power. But jurists did not shy away from exploring the relationship between the evolving doctrines of corporate law and the need to prevent potential abuses of corporate power. Using as a springboard Adolf A. Berle, Jr. and Gardiner C. Means's *The Modern Corporation and Private Property*,[74] the "ur-text" of modern corporate governance,[75] the following sections examine these early 1930s scholarly endeavors.

I should stress that my analysis in these sections is limited to exploring a strand of corporate law that has often been ignored or misunderstood. I argue that in the late 1920s and early 1930s, even as many became concerned about saving corporate America, a particular school of thought remained fo-

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70. L.S. Zacharias, *Repaving the Brandeis Way: The Decline of Developmental Property*, 82 Nw. U. L. Rev. 596, 618 (1988).

71. *Id.* at 619. For a detailed analysis of these concerns and their impact on Progressive thought, see Mitchell, *supra* note 69, at 90-112.

72. On the positions of decentralization and centralization, see Michael J. Sandel, Democracy's Discontent: America in Search of a Public Philosophy 211–21 (1996).

73. Dalia Tsuk Mitchell, *Shareholders as Proxies: The Contours of Shareholder Democracy*, 63 Wash. & Lee L. Rev. 1503, 1516-19 (2006).

74. Adolf A. Berle, Jr. & Gardiner C. Means, The Modern Corporation and Private Property (1932).

75. Mitchell, *supra* note 9, at 14.

cused on abuses of corporate power, specifically by the control group. These scholars described corporations as sovereign (or semi-sovereign) entities, accepted them as such, but wanted to constrain those who controlled them. Directors were assigned the task of reining in the control group. They were compared to public officials and viewed as trustees not only for the corporation but also for the community at large.

Each of the works discussed in the following sections portrayed directors as trustees, even as authors debated for whom exactly they were trustees. Because these works have often been misinterpreted, their cumulative impact has escaped scholarly attention. As I argue, when read in their historical context, these works support the conclusion that the first status legal scholars assigned to directors in the twentieth century was that of trustees (with corresponding heightened duties). This vision immensely influenced the policies of the New Deal.[76] It also helped legitimate the powerful public corporation. As the third part of this article will explore, by the mid 1930s, as concerns about corporate power dissipated, a different definition of the director's status prevailed—it described directors as representatives of the shareholders and assigned them the more limited task of mediating potential intra-corporate conflicts between the shareholders and the corporation's executives. When the courts endorsed this vision, they used it to justify their deference to directors' discretion. In doing so, they eroded the high standard of liability associated with the concept of trust and lay the foundation for the restatement of the business judgment rule—originally a rule recognizing human mistakes—as a rule shielding directors from liability.

B. *The Modern Corporation and Private Property*

Berle and Means's *The Modern Corporation and Private Property* was one of the earliest attempts to connect the emergence of giant corporations with the political and social changes oc-

76. Dalia Tsuk, *From Pluralism to Individualism: Berle and Means and 20th-Century American Legal Thought*, 30 LAW & SOC. INQUIRY 179, 195-96 (2005). Jurists also believed that the courts could enforce these trust obligations. But the idea of imposing a unified conception of social trusteeship on directors (and corporations) became less feasible after the U.S. Supreme Court decision in *Erie R.R. Co. v. Tompkins*, 304 U.S. 64 (1938) put an end to the idea of federal common law. *Id.* at 204.

curring in a rapidly growing industrialized society. While in the collective imagination of corporate law scholars, the book is remembered for its exegesis of the separation of ownership from control in large public corporations, Berle and Means's interests focused on corporate power. Their analysis rested on the assumption that corporations were centers of political and economic power equivalent to the power of the state. This assumption helped sustain the idea that directors were trustees for the community. In turn, viewing directors as trustees helped ameliorate concerns about corporate power that this assumption raised.[77]

Berle and Means's ideas are traceable to early-twentieth century political theories that made the group rather than the individual the focus of legal and political analysis. Resisting both the radical collectivist vision of Marxists and socialists and the individualism of traditional liberal thought, political scientists described groups, specifically functional groups like labor unions, as the fora where individuals found meaning for their ideas and actions. They argued in favor of adding groups, organizations, and associations to the existing array of local and state governments as the bases of the modern American state.[78]

77. For a detailed description of this vision, which I have labeled legal pluralism, and its history, see *id.* at 185-94; Tsuk, *supra* note 64, at 1887-88.

78. These political scientists are remembered collectively as political pluralists but their ideas varied. Some political pluralists argued that because individuals organized themselves into groups to pursue their interests, groups and organizations were loci of participation and representation. They believed that by exploring the role of groups in society they could offer a more realistic description of liberal democratic politics and the limited role of the liberal state. An example of the work of these theorists is ARTHUR BENTLEY, THE PROCESS OF GOVERNMENT 465-80 (1908). Other political pluralists not only recognized the existence of a multiplicity of centers of self-government in society, but also embraced it as a constitutive element of democracy. These theorists argued that the state was too broad and abstract a body to command loyalty and allegiance from individuals, who associated more easily with diverse groups and organizations than with a unified state entity. By conceiving of sovereignty as distributive or multiple and by encouraging the growth of organizations such as labor unions, these political theorists sought to guarantee the flourishing of diverse and valuable forms of identities, ways of life, experiences, and viewpoints. For examples of these theorists' arguments, see JOHN DEWEY, THE PUBLIC AND ITS PROBLEMS (1927); MARY P. FOLLETT, THE NEW STATE: GROUP ORGANIZATION THE SOLUTION OF POPULAR GOVERNMENT (1918); HAROLD J. LASKI, STUDIES IN THE PROBLEM OF

Drawing on such ideas, corporate legal scholars like Berle and Means recognized the significant role of corporations in an industrialized society as economic and social bases for democracy and, accordingly, described them as real entities whose existence was both real and distinct from their individual members.[79] But while, for the most part, political theorists were not concerned about the power that collective entities might exercise (trusting labor unions and corporations to self-regulate their activities), Progressive corporate law scholars exposed corporations as loci of coercive power over their members, nonmembers, and other associations, power that liberal legal thought treated as free contractual arrangements between individuals. By the 1920s, the potentials and risks of corporate (and group) power came to dominate conversations about corporate law and theory.

In this vein, Berle and Means wrote that the separation of ownership from control allowed tremendous buildups of power, and that given corporations' economic power, it was meaningless to assume that corporations were private associations, or that the state was the only center of coercive (public) power. Corporate power, they explained, was "comparable to the concentration of religious power in the medieval church or of political power in the national state."[80]

Berle and Means (and their colleagues) believed that, in principle, corporations should be allowed to exercise their powers freely but that courts should tame potential abuses of power by imposing on organizations limitations resembling the constraints on sovereign power. [81] They wanted corpora-

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SOVEREIGNTY (1917). For a sample of articles by the most known (British) political pluralists, see THE PLURALIST THEORY OF THE STATE: SELECTED WRITINGS OF G. D. H. COLE, J. N. FIGGIS, AND H. J. LASKI (Paul Q. Hirst, ed., 1989). For a contemporaneous critique of political pluralism, see W. Y. ELLIOTT, THE PRAGMATIC REVOLT IN POLITICS: SYNDICALISM, FASCISM, AND THE CONSTITUTIONAL STATE (1928), For an analysis of pluralists' scholarship, see EARL LATHAM, THE GROUP BASIS OF POLITICS: A STUDY IN BASING-POINT LEGISLATION 12-13 (1952) and, more recently, AVIGAIL I. EISENBERG, RECONSTRUCTING POLITICAL PLURALISM (1995).

79. Hager, *supra* note 64, at 579-80.

80. BERLE & MEANS, *supra* note 74, at 352.

81. *See similarly* Chester Rohrlich, *The New Deal in Corporate Law*, 35 COLUM. L. REV. 1167, 1169 (1935) ("[T]he 'New Deal' has definitely taken the view that corporations which sell securities to the public or whose securities are traded in on exchanges are not merely private business organizations

tions to exercise their power to benefit the community at large.

Indeed, having called attention to corporate power, as augmented by the separation of ownership from control, Berle and Means rejected the traditional ways of restraining corporate power that were grounded in the common law rules of property and contracts. The application of strict property rules to passive ownership, they argued, would require the control group to exercise corporate power for the benefit of the shareholder and put "the bulk of American industry" in the service of "inactive and irresponsible security owners." [82] Strict contractual rules, in turn, would have vested the control group with uncurbed power. Instead, Berle and Means proclaimed that "by surrendering control and responsibility over the active property," shareholders had released the community from the obligation fully to protect their property rights and cleared the way for placing "the community in a position to demand that the modern corporation serve not [only] the owners or the control [group] but all society." [83] Corporate power was, accordingly, power in trust for the community.

Yet, while defining corporate power as power in trust, Berle and Means said little about the appropriate role or liability of the board of directors. Turning to cases that rejected the three-tier classification of negligence, they announced that the idea that directors were only liable for fraud or gross negli-

but are 'public' institutions which, whether or not they are engaged in a business 'affected with a public interest,' are subject to special governmental supervision.").

82. BERLE & MEANS, *supra* note 74, at 354.

83. *Id.* at 354-57. It is important to remember that Berle and Means's analysis of corporate power also drew upon the Progressives' critique of the public-private distinction and their conceptualization of property rights as a delegation of coercive power to individuals. Berle and Means argued that because property, especially corporate property, was a means by which the state legitimated the use of nongovernmental coercive power, the state could require those in control of such power to promote the public interest. The classic critique of the distinction between public and private power remains Robert L. Hale, *Coercion and Distribution in a Supposedly Non-Coercive State*, 38 POL. SCI. Q. 470 (1923). On the Progressives' view of property rights, see BARBARA H. FRIED, THE PROGRESSIVE ASSAULT ON LAISSEZ FAIRE: ROBERT HALE AND THE FIRST LAW AND ECONOMICS MOVEMENT (1998).

gence gave way to a standard duty of care, [84] but their analysis went no further. Corporate power was power in trust, but how such a statement affected the directors' role or liability remained unclear. Indeed, in order to understand the early 1930s ideal of directors as trustees, we need to examine not only legal scholars' concerns about corporate power but also their distress about corporate control. As the following sections elaborate, Berle, Means, and their contemporaries were alarmed less by corporate power *per se* than by the concentration of corporate control in the hands of a few investment bankers and controlling shareholders (and, to a more limited extent, management). They wanted the corporate director to act as trustee, subject to heightened duties and liabilities, to tame the control group. Specifically, they wanted to constrain the control group's ability to harm, through its participation in corporate management or through market manipulation, both the community at large and the individual shareholder. Today we often describe the interests of the individual shareholder and the community as divergent. But because these early twentieth century scholars were concerned about both the external and the internal dimensions of corporate power, [85] they viewed them as complementary.[86]

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84. BERLE & MEANS, *supra* note 74, at 202-203. For a similar view, see Wormser, *supra* note 61, at 29-35 ("[D]irectors owe to the corporation the duty to exercise that degree of ordinary care and diligence and of reasonable business knowledge and skill which are required under the circumstances of the particular case as applicable to the type of corporation in question. Not less than ordinary care and diligence, not less than a reasonable degree of business judgment and prudence, are required. For failure to comply with the obligations imposed by this duty, directors may be held personally liable. . . . Directors actually must direct. If a person is unwilling to assume the obligation to direct, his remedy is simple—he need not become a director. . . . for it is but just and right that a man should be as careful in employing the funds of others as he would be with his own.").

85. According to Berle and Means, the external dimension of power focused on the corporation's impact on society, specifically the corporation's power to control markets by administering prices, its capacity to accumulate capital and affect the economy, and its ability to shape the forces of production through the development of new technologies. The internal dimension focused on the power of the corporation over individuals within it. BERLE & MEANS, *supra* note 74, at 6-7; BOWMAN, *supra* note 67, at 207-8.

86. Discussing the relationship between community interests and shareholders interests is beyond the scope of this paper. Gerald Frug, in his excellent analysis of bureaucratic and corporate power, argues that Progressive

C. *The Problem of Control*

Despite the growing dispersal of share ownership in the early twentieth century, control of businesses became highly concentrated. Moreover, by the 1910s, banks began to play a triple role—they were commercial lenders, institutional investors, and investment bankers. "By 1912, 18 financial institutions sat on the boards of 134 corporations with $25.325 billion in combined assets. Of these 18 institutions, 5 banks. . . sat on the boards of 68 nonfinancial corporations with $17.273 billion in assets. . . U.S. GNP in 1912 was $39.4 billion."[87]

By virtue of their capital and social networks, investment bankers became, as Brandeis put it in 1914, "[t]he dominant element in our financial oligarchy."[88] They became promoters and directors of corporations, and were able, through their economic power and the use of legal devices such as voting trusts and non-voting stock, to control even those boards on which they did not sit.[89] Gradually, investment bankers replaced control through complete ownership and even control through ownership of a large block of the votes. [90]

The individual shareholder, who in the early decades of the twentieth century gradually became a speculator, [91] was not necessarily troubled by these transformations, at least as long as she "held [a] soaring stock." [92] But economists and lawyers raised concerns about the growing power of the control group. They worried that the more dispersed stock owner-

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corporate law scholars were able to reconcile the interests of the individual shareholder with those of the community by emphasizing that directors were trustees and arguing that, as trustees, directors were authorized to determine the subjective interests of the different corporate constituencies. Frug, *supra* note 59, at 1308.

87. Miguel Cantillo Simon, *The Rise and Fall of Bank Control in the United States: 1890–1939*, 88 AM. ECON. REV. 1077, 1081 (1998). For a detailed account of these developments, see Tsuk Mitchell, *supra* note 73, at 1520-28.

88. LOUIS D. BRANDEIS, OTHER PEOPLE'S MONEY: AND HOW THE BANKERS USE IT 3 (1914).

89. *See id.* at 1–27.

90. Gardiner C. Means, *The Separation of Ownership and Control in American Industry*, 46 Q. J. ECON. 68, 72-74 (1931).

91. On the shareholder as speculator, see MITCHELL, *supra* note 69, at chs. 4 & 8; Walter Werner, *Management, Stock Market and Corporate Reform: Berle and Means Reconsidered*, 77 COLUM. L. REV. 388, 391–94 (1977).

92. RALPH F. DE BEDTS, THE NEW DEAL'S SEC: THE FORMATIVE YEARS 7 (1964).

ship became, the easier it was for the larger shareholders—typically, life insurance companies, trust companies, and banks—to control the activities of the corporation.[93] Indeed, when Berle and Means called attention to the growing separation of ownership from control in large business corporations, they pointedly explained that individual shareholders lost control not only to management, but also to larger investors who, even without owning a majority of the shares, were able to elect the board of directors.[94]

Control by a minority of the owners—be it the investment banking house, a small controlling block, or even management—was alarming mostly because of its potential for abuse and manipulation. "Power without responsibility is, philosophically, a perilous matter," Berle wrote in 1925, and "the history of minority-controlled corporations during the last thirty years amply demonstrates that the hazard is not imaginary."[95]

The role played by investment banks raised even deeper concerns. As Berle explained, because management stock would likely be controlled by the investment banking house that served as a promoter for the corporation, "it [was] possible, if not probable, that there [would] be attractive opportunities for manipulation of securities, for negotiating favorable contracts with allied interests, or even for giving value to stock which represent[ed] no real investment."[96] Given the "web of economic interests" which the investment banking house served and from which it made its profits, it was likely that management stock would be voted for transactions that benefited the investment banking house, or even the controlling groups, but not the controlled corporation. [97] Sharing Berle's views, William O. Douglas labeled the interests of investment banking houses "high finance," charging that they were "interested solely in the immediate profit."[98] According to Douglas,

93. For a less concerned view of the control group, see Franklin S. Wood, *The Status of Management Stockholders*, 38 YALE L.J. 57 (1928) (arguing against imposing stricter fiduciary duties on controlling stockholders).

94. BERLE & MEANS, *supra* note 74, at 66–111.

95. Adolf A. Berle, Jr., *Non-Voting Stock and "Bankers' Control,"* 39 HARV. L. REV. 673, 674 (1925–26).

96. *Id.* at 676.

97. *Id.*

98. William O. Douglas, *The Forces of Disorder*, Address delivered at the University of Chicago (Oct. 27, 1936) with additions from talks before the

the interests of high finance were different from those of small individual shareholders or even the corporation, but with the power of control, high finance was able to profit by siphoning money from other investors.[99]

It was in this context that scholars like Berle and Means began to express concerns about the relationship between the individual shareholder and its corporation. *The Modern Corporation and Private Property* concluded that:

> [T]he usual stockholder has little power over the affairs of the enterprise and his vote, if he has one, is rarely capable of being used as an instrument of democratic control. The separation of ownership and control has become virtually complete. The bulk of the owners have in fact almost no control over the enterprise, while those in control hold only a negligible proportion of the total ownership.[100]

While Berle and Means did not necessarily think shareholders could effectively participate in corporate management, they strongly believed in the potential effectiveness of fiduciary duties. Accordingly, their proclamation that corporate power was power in trust meant that directors, as trustees, were responsible for preventing those in control from abusing their power, especially their power to direct the affairs of the corporation and their power to manipulate the stock market.

Concerns about market manipulation also led Berle to argue that directors were trustees for the corporation's shareholders. Because he viewed the questions through the lenses of corporate power and corporate control, Berle saw the obligations of directors to the community and to the shareholders, especially minority shareholders, as complementary. Beginning in the late 1930s, however, mainstream corporate legal scholarship rejected Berle's concerns. His statements about the subject have thus been misunderstood. At least in part, the

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Economic Club of Chicago (Feb. 1, 1938) and before the Bond Club of New York (Mar. 24, 1937), *in* DEMOCRACY AND FINANCE: THE ADDRESSES AND PUBLIC STATEMENTS OF WILLIAM O. DOUGLAS 9 (James Allen ed., 1940).

99. *Id.*

100. BERLE & MEANS, *supra* note 74, at 83. *See also* Means, *supra* note 90, at 97 (noting that "[t]he individualism of Adam Smith's private enterprise has in large measure given way to the collective activity of the modern corporation, and economic theory must shift its emphasis from analysis in terms of competition to analysis in terms of control.").

confusion reaches back to Berle's debate with E. Merrick Dodd about directors' trusteeship duties. The following section provides background for the debate by briefly summarizing the Progressives' concerns about fraudulent market practices. I will then demonstrate how Berle's argument that directors were trustees for the shareholders was shaped by his early work on the duties of directors toward individual shareholders. In these early writings, his concerns focused on market manipulation by the control group.

D. *The Risks of Market Manipulation*

Preventing those in control of the corporation from manipulating stock price was the focus of much discussion in the first two decades of the twentieth century. The typical context in which it arose was directors' (and officers') purchase of stock in their corporation. Focusing on the liability of corporate directors "to stockholders from whom or to whom they buy or sell stock," jurists narrowed down the issue to "the question of whether the trading director must disclose his knowledge of the corporate affairs to the stockholder, and if so, how, and to what extent."[101]

By the 1920s, many considered the separation of ownership from control and the rise of professional management as creating increased corporate gains and profits. Management was seen as "the prime mover of business—the veritable fountain-head of economic security for the bulk of the population."[102] With this in mind, while some legal scholars held directors as fiduciaries not only to the corporation but also to its individual shareholders, others (perhaps even the majority position), argued that stockholders were "quite as apt to be strong, wise, and sagacious as directors."[103] Moreover, they proclaimed that anonymous markets made disclosure by directors and officers unfeasible.[104]

Berle, writing in 1928, sided with advocates of the former position. "With neither power nor information, the stock-

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101. Adolf A. Berle, *Publicity of Accounts, Management Purchase of Stock and Control of Security Value, in* STUDIES IN THE LAW OF CORPORATIONS FINANCE 177 (1928).
102. *Business Versus the Public,* 8 ACCT. REV. 162 (1933).
103. Berle, *supra* note 101, at 178.
104. *Id.* at 177-79.

holder becomes merely the beneficiary—*cestui*—of the corporate management," he wrote. "Deprive him of any right by way of fiduciary relation, and the business becomes too hazardous to continue." As Berle saw it, the fiduciary duties of directors and officers extended to the corporation as well as to its shareholders.[105]

Indeed, while it seemed efficient to let professional executives run corporations, tremendous imbalances of power lurked in this arrangement because of the lack of federal laws requiring and regulating corporate disclosure and inadequate self-regulation by the exchanges. By virtue of their positions, individual businessmen were thus able to benefit at the expense of the public. As one editorial put it, "[m]any managements, swollen with power, came to believe that their enterprises had ceased to be reservoirs of trust funds for stockholders and creditors but had become agencies for their own private immediate gain." [106] Huge salaries and bonuses, management's participation in its own underwriting, using corporate funds to manipulate the market, and other forms of self-dealing became common. Rather than being an "economic savior," management turned out to be "often without vision, incapable of self-regulation, unmindful of duties to investors, and almost unaware of its responsibilities to society as a whole."[107]

The market's collapse in October 1929 painfully brought home the consequences of the "feverish activity of speculation" that characterized the 1920s.[108] But the blame for the crash was laid not only on speculation, but also on the fraudulent practices which helped fuel speculation: inadequate cor-

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105. *Id.* at 179-81.

106. *Business Versus the Public, supra* note 102, at 163.

107. *Id.* Stock market manipulation was not a novel idea. *See, e.g.*, *A Soulless Corporation*, THE INDEPENDENT, June 18, 1863, *available at* APS Online (reporting that the directors of the Cleveland and Toledo Railroad Company used their control of the company's books privately to acquire sufficient stock to guarantee their reelection); *The Mismanagement of Railway and Other Corporations and the Remedy*, THE ALBION, Nov. 28, 1868, *available at* APS Online ("The reckless manner in which the directors of railway and other companies have increased the capital stock of their respective corporations during the last few years, and more particularly during the last eighteen months, for stock jobbing purposes, is a grave public evil which calls for legislative interference.").

108. DE BEDTS, *supra* note 92, at 11.

porate reporting, self-perpetuating boards, managements manipulating insider information, and faulty credit control.[109]

The consequences were devastating. According to one report, "in the ten years before 1933, total investor losses through worthless securities were approximately $25 billion, or half of all those issued."[110] According to the same report, even before the Depression, investors' losses "reached a staggering annual total of $1.7 billion, of which $500 million alone was accounted for within the state of New York."[111] Not surprisingly, the securities markets (specifically, disclosure) became the focal point for reform.[112]

The different drafts of the Securities Act of 1933 reflected the idea that federal legislation should be limited to requiring "full and fair disclosure of the nature of the security being offered and that there should be no authority to pass upon the investment quality of the security."[113] The 1934 Act focused on the registration of the stock exchanges and the requirement that firms traded on these exchanges file annual and quarterly reports with a newly established agency created by the Act—the Securities and Exchange Commission. The Act further prohibited certain manipulative devices such as short selling, which corporate insiders and exchange members used to exploit the market, and it regulated insider trading by both management and controlling shareholders.[114]

The Berle-Dodd debate took place shortly prior to the enactment of the Securities Acts. As the following section ex-

109. *See* H.R. Rep. No. 73-1383, at 5–6 (1934).

110. De Bedts, *supra* note 92, at 11.

111. *Id.*

112. *Id.* at 12.

113. Joel Seligman, The Transformation of Wall Street: A History of the Securities and Exchange Commission and Modern Corporate Finance 63 (1982) (quoting James Landis's recollection of the drafting of the Securities Act of 1933). *See also* Rohrlich, *supra* note 81, at 1169 (noting that "faith in publicity" was the theme underlying the New Deal policies).

114. De Bedts, *supra* note 92, at 76–77. *See also* Nelson, *supra* note 2, at 289 (noting that the Securities Acts "were designed to protect investors from money managers who manipulated markets for their own profit at investors' expense."). The section dealing with insider trading in the 1934 Act was section 16(b), applicable to officers, directors, and shareholders who own more than 10 percent of a company's stock in specific circumstances. The more famous rule 10b-5, applicable to any person, was promulgated later under section 10(b) of the Act.

plains, it originated in Berle's attempt to use corporate law to supplement the anticipated federal regulation by instructing directors as to how to prevent the control group from manipulating stock price and the market, more broadly. Focusing on the relationship between directors and shareholders, it inadvertently set the stage for the mid twentieth century's re-envisioning of directors as representatives of the shareholders rather than as trustees for the corporation, its shareholders, and the community. This shift will be the focus of the third part of this article.

E. *For Whom Are Corporate Directors Trustees?*

The Modern Corporation and Private Property concluded that corporate powers were powers in trust for the community. As already noted, what this meant was less obvious. The book's last paragraphs stated:

> Neither the claims of ownership nor those of control can stand against the paramount interests of the community. . . . It remains only for the claims of the community to be put forward with clarity and force. Rigid enforcement of property rights as a temporary protection against plundering by control would not stand in the way of the modification of these rights in the interest of other groups.[115]

Interestingly, shortly before the publication of *The Modern Corporation and Private Property,* Berle published an article that seemed to contradict this statement, arguing that corporate powers were held in trust for the benefit of the shareholders.[116]

Despite such inconsistencies, one would be mistaken to assume that Berle was of two minds when it came to the duties of directors (and officers). Such an assumption pays too much homage to the only public response to Berle's article—E. Merrick Dodd's article, *For Whom are Corporate Managers Trustees?* Dodd, whose vision of corporate management clearly was one of public service, was keen on validating corporate social policies that benefited the public, including employees, consum-

115. BERLE & MEANS, *supra* note 74, at 312.
116. Adolf A. Berle, Jr., *Corporate Powers as Powers in Trust,* 44 HARV. L. REV. 1049 (1931).

ers, creditors and the community at large, even in situations in which the result could be a diminution of profits for the shareholders. Announcing that he was "thoroughly in sympathy with Mr. Berle's efforts to establish a legal control which [would] more effectually prevent corporate managers from diverting profits into their own pockets from those of stockholders," Dodd nonetheless emphasized that the corporation was "an economic institution" with "social service as well as a profit-making function."[117]

Dodd's justification drew upon public opinion, specifically the views of corporate managers like Owen D. Young, chairman and president of General Electric, who maintained that the corporation should recognize its "public obligations and perform its public duties—in a word, vast as it is, that it should be a good citizen."[118] Yet, as I explain below, Berle's article did not contradict such a statement. Dodd's attack was misguided.

Berle's *Corporate Powers as Powers in Trust,* which was written shortly after the collapse of the market, was an argument designed to eliminate the potential for managerial abuse of its market powers. It was nothing more than a continuation of Berle's 1928 article on the relationship between directors, officers, and individual shareholders.[119] Berle wanted to protect those who were not in control of the corporate machinery from fraud and manipulative practices that, at the time, plagued the securities markets. Each of the powers enumerated in the article corresponded to Berle's previous writings about the problem of control.[120] Each was also a power previously considered a matter of contract law.[121] Berle wanted to make these powers a matter of the directors' trusteeship duties.

Corporate Powers as Powers in Trust examined five powers. First was the power to issue stock, which Berle wanted to "subject to the equitable limitation that such issue must be so accomplished as to protect the ratable interest of existing and

117. E. Merrick Dodd, Jr., *For Whom Are Corporate Managers Trustees?* 45 HARV. L. REV. 1145, 1147-48 (1932).

118. *Id.* at 1154.

119. *See supra* notes 101-105.

120. Among these writings were Berle, *supra* note 95, at 674, and Adolf A. Berle, *High Finance: Master or Servant,* 23 YALE REV. 20, 41–42 (1933).

121. Uhlman, *supra* note 59, at 18.

prospective shareholders."[122] Second was "the power to declare or withhold dividends," which, as Berle argued, had to be used so as to benefit all shareholders rather than one class of shareholders or some shareholders within a given class.[123] Third was "the power to acquire stock in other corporations." [124] Berle wanted to guarantee that such power would not be used "to forward the enterprises of the managers as individuals or to subserve special interests within or without the corporation."[125] Fourth was "the reserved power of the corporation to amend its charter." [126] Berle argued that such power had to "be so exercised that the result will tend to benefit the corporation as a whole, and to distribute equitably the benefit or the sacrifice, as the case may be, between all the groups in the corporation as their interest may appear."[127] Fifth was "the power to transfer the corporate enterprise to another enterprise by merger, exchange of stock, sale of assets or otherwise." [128] Again, Berle wanted to guarantee that the interests of all classes of shares were "respectively recognized and substantially protected" in such transactions.[129]

Given the particular goals of his article, Berle did not anticipate Dodd's rebuttal. Stressing, perhaps too apologetically, that lawyers "know what the social theorist does not," Berle's response to Dodd repeated that those in control did not see themselves as fiduciaries.[130] Any weakening of their obligations toward the shareholders would thus make their power absolute. "You cannot abandon the emphasis on 'the view that business corporations exist for the sole purpose of making profits for their stockholders' until such time as you are prepared to offer a clear and reasonably enforceable scheme of responsibilities to someone else," Berle wrote.[131]

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122. Berle, *supra* note 116, at 1050-60.
123. *Id.* at 1060-63.
124. *Id.* at 1063.
125. *Id.* at 1063-66.
126. *Id.* at 1066.
127. *Id.* at 1066-69.
128. *Id.* at 1069.
129. *Id.* at 1069-72.
130. Adolf A. Berle, Jr., *For Whom Corporate Managers Are Trustees: A Note,* 45 HARV. L. REV. 1365, 1367 (1932).
131. *Id.*

Berle did not reject (nor recant) the view that corporate powers were powers in trust for the community. Fraud and market manipulation by management and the control group, however, posed an immediate threat to the securities markets. Berle thus argued that the corporation could play its public, trustee role only when that threat to corporate capitalism was removed. He agreed with Dodd that the economic power that was "mobilized and massed under the corporate form" was beneficial to society only as long as its excesses were prevented. But he criticized Dodd's position as theoretically sound and practically dangerous. Dodd's position ran the risk of undermining Berle's attempts both to legitimate the modern public corporation and to constrain potential abuses of corporate power. As Berle saw it, rather than taming corporate power, it would bring group warfare into corporations and allow "the massing of group after group to assert their private claims by force or threat." [132] "Either you have a system based on individual ownership of property," he wrote, "or you do not."[133]

Dodd's position was elitist; it was traced back to the ideas of "such 'best men' as Henry Adams, John Hay, and Henry Cabot Lodge, that relied upon the breeding and values and education of a superior class to fulfill its civic responsibility." [134] Like these "best men," Dodd believed that business respect for traditional moral values would produce material rewards and help rejuvenate the nation. But Dodd continued to lump together officers and directors, not recognizing the need to create a particular role for the modern board. Berle's *Corporate Powers as Powers in Trust* was indeed one of the first attempts to define a role for the board, as distinguished from managers. Berle wanted the board to rein in those in control of the enterprise lest they harm not only the community but also the individual shareholders subject to their powers. Ironically, by emphasizing the directors' role in protecting the corporation's shareholders, he helped pave the road for the erosion of his own ideas.

132. *Id.* at 1368.

133. *Id.* For more on the Berle-Dodd debate, see Tsuk, *supra* note 64, at 1891-96; Tsuk, *supra* note 76, at 205-09.

134. LAWRENCE E. MITCHELL, CORPORATE IRRESPONSIBILITY: AMERICA'S NEWEST EXPORT 187 (2001). For a broader discussion of the idea of "best men," see JOHN G. SPROAT, THE BEST MEN: LIBERAL REFORMERS IN THE GILDED AGE (1968).

As the third part of this article explains, shortly after it was articulated, Berle's nuanced understanding of the relationship between corporations, their directors, and the community faded away as new concerns came to characterize discussions about the board's role, status, and liability. Beginning with analyses of the securities acts and rules promulgated under them, and filtering down to the state courts' scrutiny of directors' fiduciary duties and the emergence of the modern business judgment rule, discussions from the mid 1930s through the 1970s focused not on corporate power or market manipulation but on corporate hierarchies and the need to enhance corporate democracy. The idea that directors were trustees for the community, which helped legitimate corporate power, was replaced with the notion that directors were representatives of the shareholders. (As will become apparent, the concept of representation was different from the notion of agency that has characterized discussions about the board's role in the last three decades of the twentieth century.[135]) I begin with William O. Douglas's *Directors Who Do Not Direct*, perhaps the most significant work to anticipate and help bring about, albeit unintentionally, the transformation of the prevailing view from directors as trustees to directors as representatives.

III.
1930s-1970s: Directors as Representatives

A. *Directors Who Do Not Direct*

Directors Who Do Not Direct was published in 1934, shortly after the enactment of the Securities Acts, and three years before Douglas was to become the SEC Chairman. It was recently described as "the first important discussion of the appropriate function of the board."[136]

Douglas began his discussion by reiterating the "many different abuses and malpractices" of the 1920s—"secret loans to officers and directors, undisclosed profit-sharing plans, timely contracts unduly favorable to affiliated interests, dividend policies based on false estimates, manipulations of credit resources and capital structures to the detriment of minority interests, poor operations, and trading in securities of the company by

135. The concept of agency is discussed in the fifth part of the article.
136. Mitchell, *supra* note 9, at 16.

virtue of inside information, to mention only a few."[137] As Douglas saw it, all these indicated that businessmen had lost sight of their public role.[138]

Douglas believed that the newly enacted securities laws offered some protection to shareholders by requiring accurate disclosure in the proxy solicitation process, but he did not think such disclosure was sufficient. First, Douglas thought that disclosure was inadequate if it meant "registration in some dusty file in Washington or in some state capitol."[139] He wanted mandatory disclosure "in the sense of direct and unequivocal statement in the periodical reports to stockholders."[140] As part of this, Douglas would demand disclosure of directors' compensation, the shares traded by directors during any given period, and directors' affiliations and conflicts of interests.[141] But Douglas also believed that only direct prohibition could be effective in certain situations (for example, the separation of commercial from investment banking under the Glass-Steagall Act).[142]

Seeking to encourage "the development of a social mindedness. . . among business men and their legal advisers,"[143] Douglas's attention, however, focused not on federal regulation but on corporate law. He wanted to make the board independent of management. While Berle and Means's analysis focused on corporate power, particularly the power of the control group to manipulate the market, Douglas's main concern was management's control of the board, which, he believed, was at the root of the problems of the 1920s.[144]

As Douglas saw it, the purpose of the board of directors was to protect shareholders from management. He stressed the need to guarantee that directors would not be "called in by the managers," drawn from the managers, or be subordinate to the managers in any way. In short, Douglas wanted to take "control or dominance of the board away from the executive

137. William O. Douglas, *Directors Who Do Not Direct*, 47 HARV. L. REV. 1305, 1306 (1934).
138. *Id.*
139. *Id.* at 1323.
140. *Id.*
141. *Id.*
142. *Id.* at 1324–25.
143. *Id.* at 1307.
144. Mitchell, *supra* note 9, at 17.

management."[145] As he concluded, independent directors, "the representatives of the stockholders, would be there, not for the purpose of managing the enterprise, but with the object of supervising those who do and of formulating the general commercial and financial policies under which the business is to be conducted."[146]

In short, while the executives were to manage the corporation, the independent board of directors was assigned the task of setting the corporation's policies and agenda and monitoring the executives, lest they abuse their managerial power to benefit themselves or the control group. Douglas conceded that the independent directors "would not always be in a position to know the details of the business in such a way as to satisfy the standards which the Securities Act, for example, imposes on them."[147] But, he stressed, "they would be in a position of dominance and power to serve the stockholders effectively."[148] In fact, Douglas believed that the independent directors should be elected from among the shareholders.[149]

In an address delivered five years after the publication of *Directors Who Do Not Direct*, Douglas went even further, suggesting that outside, independent directors should be "paid for their work in proportion to the actual contributions made by them."[150] Pay, he suggested, would go a long way toward the creation of a professional director.[151] It would allow outside, independent directors to protect the interests of the small stockholder as well as the community. "Since the beginning of corporate history—and particularly since corporations began to turn to the public for their funds," Douglas explained, "it has been recognized that the interests of the shareholders could not be adequately served by management alone. . . . The check of a board of vigilant, well-informed directors is needed to assure that management is always loyal, honest, and prudent."[152]

145. Douglas, *supra* note 137, at 1314.
146. *Id.*
147. *Id.*
148. *Id.*
149. *Id.* at 1314-15.
150. William O. Douglas, *Corporation Directors*, *in* DEMOCRACY AND FINANCE, *supra* note 98, at 47.
151. *Id.* at 52-53.
152. *Id.* at 50.

Lest he be misunderstood, Douglas emphasized that corporate powers were powers in trust. As he put it, "directors are trustees by virtue of business ethics as well as law, and the powers which they exercise are powers in trust."[153] "The paid director," he similarly pointed out in 1939, "would revive and strengthen the tradition of trusteeship. . . . In a larger sense, he would not be so much a paid director or a professional director as a *public* director, representing not only the present but the potential stockholder, and representing the general public as well."[154]

In the end, while Douglas's focus was not corporate power but corporate internal hierarchies, he, like Berle, saw no contradiction between the directors' role as trustees for the community and their role as representatives of the shareholders. Douglas's and Berle's writings focused on the need to tame and constrain those in control, whether large investors or management. Demanding that corporations act as trustees for the community and that directors represent the interests of the shareholders were thus complementary requirements.

Douglas's *Directors Who Do Not Direct* concluded by stressing the need to develop "adequate administrative controls so that the domain of regulation will be neither wholly in the courts nor largely *ex post facto*."[155] Douglas wanted to see the development of a professional managerial class, "skilled in the technique of business, the art of law, and the skill of government."[156] Such a class, he believed, could monitor corporations so as to align the interests of the shareholders with the interests of the public—"so that the profit motive will be articulated with the public good" and the investor assured "more protection against the malpractices of management."[157]

Berle's and Douglas's arguments did not stimulate a continuing scholarly debate about the role or legal status of the board of directors. The policies of the New Deal seriously cir-

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153. Douglas, *supra* note 137, at 1322. *See also* Douglas's decision in *Pepper v. Litton*, 308 U.S. 295, 306 (1939). ("A director is a fiduciary. So is a dominant or controlling stockholder or group of stockholders. Their powers are powers in trust."). While *Pepper* examined the duty of loyalty, Douglas seemed to have meant his statement to have broader applicability.

154. Douglas, *supra* note 150, at 53.

155. Douglas, *supra* note 157, at 1328.

156. *Id.*

157. *Id.*

cumscribed the corporation's powers. The Securities Acts regulated the corporation's dealings with its shareholders as well as its creditors, new federal labor laws regulated the corporation's relations with its employees, and antitrust laws affected the corporation's behavior toward consumers and suppliers.[158] Concerns about the corporation's external power rapidly dissipated while legal scholarship about corporate internal hierarchies focused on the board's control of the proxy machinery and its duty of loyalty.[159]

At the same time, however, the idea that directors were representatives of the shareholders significantly influenced state corporate law, specifically developments relating to the shareholders' ability to sue directors for breaches of their fiduciary obligations. As the following sections explain, viewing directors as representatives substantiated the courts' growing deference to directors' expertise and discretion. Ironically, just as the notion that directors were representatives of the shareholders was disassociated from the idea that they were trustees for the community, the courts' deferential approach paved the road for the erosion of directors' liabilities toward their corporations and their shareholders. I start, however, by using the early 1940s developments in securities regulation to illustrate the rise of democracy as a legitimating concept. This is the backdrop for the developments that will be discussed in the following section.

B. *Democracy as a Foundational Concept: The Shareholder Proposal Rule*

The main actors in the SEC believed that its role was to promote capitalism. They thought government planning was required to guarantee the financial stability that was necessary to sustain capitalism. They presumed that the SEC would both "encourage rational organization within private groups and between private groups in order to achieve that stability," and

158. Herbert Hovenkamp, *The Classical Corporation in American Legal Thought*, 76 GEO. L. J. 1593, 1688 (1988). *See also* E. Merrick Dodd, Jr., *The Modern Corporation, Private Property, and Recent Federal Legislation*, 54 HARV. L. REV. 917 (1941) (discussing the impact of the New Deal legislation on the relationship between management and security holders).

159. Mitchell, *supra* note 9, at 17.

eliminate those market practices that threatened it.[160] In short, the SEC "was both policeman and promoter; a vehicle for reform and a shield against more violent change."[161]

The business community was initially rather troubled by the liability clauses of the 1933 Act, which imposed civil liability on corporations and their officers for fraud and for misstatements in the registration statement.[162] But by the early 1940s, it, too, came to believe that "the law, effectively enforced, assisted financial operations by policing marginal elements within the industry and by promoting minimum standards of disclosure." [163] As more businessmen joined the government's war efforts, their influence grew. Gradually, it also became apparent that the SEC was not against corporations or "the profit motive." [164] In fact, it seemed that the commissioners and staff members saw the SEC as "an extension of business enterprise."[165] Between 1934 and 1940, the Commission, "utilizing full disclosure, investigations, stop orders, stock exchange surveillance, and participation in utility organization, only reduced opportunities for corporate theft and restricted the methods by which individuals, while inflicting pecuniary damage upon one another, could derange the entire economy."[166]

Meanwhile, the number of individual shareholders continued to rise. By 1934, the House Report on the Securities Exchange bill estimated that more than 10 million individuals owned stocks or bonds, and that "over one fifth of all the corporate stock outstanding in the country [was] held by individuals with net incomes of less than $5,000 [$79,289.23 in 2007 dollars] a year."[167] In addition, it noted that more than 15 million individuals held insurance policies, more than 13 million had "saving accounts in mutual savings banks" and at least 25 million had "deposits in national and State banks and trust

160. MICHAEL E. PARRISH, SECURITIES REGULATION AND THE NEW DEAL 179-80 (1970).

161. *Id.* at 180.

162. DE BEDTS, *supra* note 92, at 50.

163. PARRISH, *supra* note 160, at 229.

164. *Id.* at 231.

165. *Id.*

166. *Id.* at 232.

167. H.R. Rep. No. 73-1383, at 3 (1934).

companies—which [were] in turn large holders of corporate stocks and bonds."[168]

In this atmosphere, reformers' attention shifted from corporate power to corporate hierarchies, specifically to the relationship between shareholders, managers, and directors. For one thing, in 1943, the SEC adopted the shareholder proposal rule to encourage shareholder participation in corporate affairs (or shareholder democracy). The rule required the board of directors to include (albeit within limits) proposals from shareholders in its proxy solicitation. As Milton Freeman, the draftsman of the rule, explained, the SEC envisioned as the principal beneficiary of the rule the small shareholder who treated her investment as a long-term investment. In a world growingly concerned about the ability of American democracy to resist totalitarianism, SEC Chairman Ganson Purcell and his colleagues wanted to protect the individual shareholder against the corporation's management. The directors, viewed as the shareholders' representatives (or fiduciaries), were entrusted with the task of mediating the conflict between management and shareholders.[169]

The shareholder proposal rule has had a long and complex history and today its potential force has been significantly eroded.[170] In 1947, however, the Third Circuit embraced its drafters' ideals. In *SEC v. Transamerica*, a case that established the power of the SEC to determine which shareholder proposals were "proper subjects" for inclusion in a corporation's proxy statement, the court proclaimed that the shareholder proposal rule (and proxy rules more broadly) were a means of reminding a corporation's executives that a "corporation is run for the benefit of its stockholders and not for that of its managers."[171]

Stronger endorsements came in the 1950s from proponents of shareholder democracy. For example, David Bayne announced that "the failure of democracy within the modern American corporation is the failure of democracy *pro tanto* in

168. *Id.* at 3–4.
169. Tsuk Mitchell, *supra* note 73, at 1547-53.
170. *Id.* at 1554-60, 1565-73.
171. SEC v. Transamerica, 163 F.2d 511, 517 (3rd Cir. 1947).

our culture,"[172] while Frank Emerson and Franklin Latcham concluded that the shareholder proposal rule reflected "the right of a minority to express itself and have an exchange of ideas—all in a corporate context—but close to a fundamental freedom."[173]

The interest in shareholder democracy mirrored what Morton Horwitz has labeled "the emergence of democracy as a basic concept in American constitutional law" during the early 1940s.[174] Horwitz traces this phenomenon to the personal and professional impact that the barbarities of totalitarianism in Europe had on American social scientists. Having devoted the early decades of the twentieth century to challenging absolutist theories in law, politics, and morals, these social scientists were left to wonder why America had been spared the ravages of European dictatorship. Political and legal theorists beginning in the late 1930s thus struggled to explain the contrast between democratic and non-democratic societies. As Horwitz notes, "this new obsession with democratic theory was designed to show how America had managed to avoid succumbing to European totalitarianism."[175]

Proponents of the shareholder proposal rule and shareholder participation, more broadly, wanted to give shareholders a more direct way to influence corporate affairs. They envisioned the annual meeting as an exercise in participatory democracy. However, as I have previously argued, "by protecting

172. David C. Bayne, S.J., *The Basic Rationale of Proper Subject*, 34 U. DET. L.J. 575 (1956–57).

173. FRANK D. EMERSON & FRANKLIN C. LATCHAM, SHAREHOLDER DEMOCRACY: A BROADER OUTLOOK FOR CORPORATIONS 117 (1954).

174. Morton Horwitz & Orlando do Campo, *When and How the Supreme Court Found Democracy—A Computer Study*, 14 QUINNIPIAC L. REV. 1, 28 (1994).

175. *Id.* at 28-29 (1994). On the emergence of democracy as a fundamental constitutional principle during the war years, see also Morton J. Horwitz, *Foreword: The Constitution of Change: Legal Fundamentality without Fundamentalism*, 107 HARV. L. REV. 32, 58-65 (1993); EDWARD A. PURCELL, JR., THE CRISIS OF DEMOCRATIC THEORY: SCIENTIFIC NATURALISM AND THE PROBLEM OF VALUE (1973). For a judicial endorsement of the relationship between corporations and American democracy, see A. P. Smith Mfg. Co. v. Barlow, 98 A.2d 581, 586 (N.J. 1953) (noting the contributions of corporations to the national welfare and success during World War I, the Depression, and World War II, and stressing that corporations could play an important role in sustaining American democracy during the Cold War by making contributions to academic institutions).

the rights of individual shareholders to participate in their corporations annual meetings," these reformers "hoped not only to constrain the board but also to legitimate its power to run the corporation." [176] Such hopes sat well with the ideology of managerialism that dominated corporate law at least through the 1960s. Managerialists entrusted corporate managers to run the corporation without much interference from the shareholders. Moreover, such hopes reflected the influence of a different ideal of democracy that prevailed in the mid century discussions about the role of the board of directors, that is, the ideal of representative democracy. In 1931, for example, an article in the Wall Street Journal noted that:

> Corporate administration is in theory an example of strictly representative government. Stockholders are supposed to elect directors who are responsible for the general conduct of the enterprise. The directors' task is to choose managers whose business is to execute the general policies laid down by the directors to whom they are primarily responsible for the general conduct of the enterprise. If they do not perform it is the directors' duty to remove them. If the directors do not perform, it is the stockholders' right to remove them. . . . Representative government and not direct democracy is the theory.[177]

While the idea that corporate democracy was a representative democracy floated earlier in the twentieth century, it became more pronounced beginning in the mid 1930s. By the early 1940s, as more shareholders attempted to use the derivative suit to challenge directors' actions[178] (and perhaps also as a backlash against the ideas of shareholder democracy), the courts (with New York courts in a leading role) drew on the ideal of representative democracy to interpret the business judgment rule so as to limit the shareholders' ability to challenge directors' actions. Viewing the rule as a rule of defer-

176. Tsuk Mitchell, *supra* note 73, at 1512-13.

177. Thomas F. Woodlock, *Careless Owners: How Shall the Supreme Inertia of the American Stockholder Be Overcome*, WALL ST.J., April 22, 1931.

178. On the history of derivative suits, see Lawrence E. Mitchell, *Gentleman's Agreement: The Antisemitic Origins of Restrictions on Stockholder Litigation* (Pub. Law and Legal Theory Research Paper Series, Working Paper No. 44, 2002), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=321680.

ence to directors' expert opinion, New York courts expanded its scope to give more discretion to directors (and executives) to attend to the affairs of the corporation without interference from the shareholders.

Like Berle and Douglas, mid century progressive corporate law scholars typically believed that directors should represent the interests of the shareholders and the community at large—that the ideal of representative democracy would constrain abuses of corporate power without limiting the corporations' benefits for the economy. [179] Their understanding of the business judgment rule was grounded in a strong endorsement of bureaucratic expertise. [180] But the mid century's vision of directors as representatives helped justify absolute deference to the board's discretion. Moreover, as I argue in the fourth part of this article, beginning in the 1970s, the idea that directors were mediators between shareholders' interests and managerial control gradually led to the description of directors as agents of the shareholders whose role was to monitor the executives. In this context, the business judgment rule

179. Abram Chayes's 1960 article, *The Modern Corporation and the Rule of Law,* is a good example of this position. Chayes admitted that prior to the emergence of the modern public corporation, "the shareholders were the electorate, [and] the directors the legislatures, enacting general policies and committing them to the officers for execution." Abram Chayes, *The Modern Corporation and the Rule of Law,* in THE CORPORATION IN MODERN SOCIETY 25, 39 (Edward S. Mason ed., 1960). But he argued that in the twentieth century, while the analogy between corporate management and representative democracy remained the same, the conception of membership (or electorate) had to be expanded to include "all those having a relation of sufficient intimacy with the corporation or subject to its power in a sufficiently specialized way." *Id.* at 41. "The thrust of the present argument," he noted, "suggests that the *internal* structure of the corporation can also be fruitfully seen as a federation of associational groupings." *Id.* at 45. For Chayes, as for other progressive corporate law scholars in the 1960s (a minority position at that point), representative democracy was the foundation for a corporate structure that could "assure more responsible exercise of power"; it was "the institutional structure of the modern corporation." *Id.* at 39.

180. *See similarly* Frug, *supra* note 59, at 1320-22. It is interesting to note that earlier cases affirming deference to the corporation's decision-making body often involved minority shareholders objecting to the majority shareholders' actions. In such a context, judicial deference was deference to majoritarian rule rather than to expert opinion. *See, e.g.*, Gamble v. Queens County Water Co. 25 N.E. 201, 202 (N.Y. 1890) ("[T]he court would not be justified in interfering even in doubtful cases, where the action of the majority might be susceptible of different construction.").

gained a force of its own. Rather than a rule grounded in the idea of representative democracy and the need to protect directors' discretion, it became a means of legitimating the directors' late twentieth century rather limited role and limited, if any, liability.[181]

C. *The Representative Director in Court and the Modern Business Judgment Rule*

In a provocative 1960 article entitled *The Statutory Requirement of a Board of Directors: A Corporate Anachronism*, Robert A. Kessler concluded that in a majority of jurisdictions, the board of directors was regarded as "a kind of a group of Platonic guardians whose right to rule was a legislative mandate."[182] Accordingly, shareholders could not "give orders to the directors, or act for the corporation, unless by unanimous vote or agreement." [183] As Kessler pointedly put it:

> Although the cases do not make it express, they indicate that the status of the board of directors is analogous to that of a legislative body under a "delegative" theory of democratic government. The directors have been held to be the "representatives" of the entire body of shareholders and hence not subject to the dictates of even a majority of their "constituents," the shareholders. Their decisions are required to be made at a board meeting, at which they may not be represented by proxy, although each director individually consents to the proposed action. Such a re-

181. Stephen Bainbridge draws a similar distinction between the modern trend to view the business judgment rule as a standard of liability and the idea that the business judgment rule is a doctrine of abstention. Stephen M. Bainbridge, *The Business Judgment Rule as Abstention Doctrine*, 57 VAND. L. REV. 83, 88-102 (2004). *See also* Stuart R. Cohn, *Demise of the Director's Duty of Care: Judicial Avoidance of Standards and Sanctions Through the Business Judgment Rule*, 62 TEX. L. REV. 591, 594 (1983) (noting that while the business judgment rule "began as an adjunct to duty of care standards designed to protect directors' decisions against hindsight evaluation when appropriate diligence had been exercised, [it] has enveloped the primary inquiry"); Lyman Johnson, *The Modest Business Judgment Rule*, 55 BUS. LAW. 625, 633 (2000) (distinguishing between the business judgment rule—"a policy of *judicial review*" and the duty of care—"a legal standard which specifies the manner in which directors must discharge their duties").

182. Kessler, *supra* note 10, at 697.

183. *Id.* at 700.

> quirement can be justified only on the ground that the board of directors is a deliberative body of "the elect," analogous to the conception held by the founding fathers for the United States Senate.[184]

The leading jurisdiction was New York where cases in the 1930s typically demonstrated "respect for the board of directors as an inviolable institution" with whose actions the shareholders could not intervene.[185] Take, for example, *McQuade v. Stoneham*, a case involving an agreement between a majority of the shareholders of the National Exhibition Company to ensure that all three of them continued to serve as directors and officers and to receive a set amount of salary, or dividends, from the corporation. Writing for the majority, Judge Pound of the New York Court of Appeals declared the agreement void. As he explained: "the stockholders may not, by agreement among themselves, control the directors in the exercise of the judgment vested in them by virtue of their office to elect officers and fix salaries. . . . Directors may not by agreements entered into as stockholders abrogate their independent judgment."[186]

Beyond their refusal to allow shareholders to control the board (even in closely held corporation), courts were also disinclined to evaluate directors' decisions. Since the turn of the twentieth century, New York courts expanded the nineteenth-century rule that exempted directors from liability for honest mistakes[187] to include all matters entrusted to the directors' discretion. [188] For example, in 1914, Judge Cardozo wrote that mere disagreement about the expediency of particular transactions was not a reason for "the court. . . to revise the judgment

184. *Id.* at 701.

185. *Id.* at 698.

186. McQuade v. Stoneham, 189 N.E. 234, 236 (N.Y. 1932). According to Kessler, the only exception to this rule was Clark v. Dodge, 199 N.E. 641 (N.Y. 1936), which involved a closely held corporation in which the only two shareholders were the officers and directors of the corporation. Kessler, *supra* note 10, at 698.

187. On the earlier articulation of the business judgment rule, see *supra* note 20.

188. Although some courts went in the opposite direction and limited the exemption for honest mistakes. *See* Rohrlich, *supra* note 81, at 1191.

of the directors, and substitute its conclusion for theirs."[189] In a similar manner, in 1931, in *City Bank Farmers' Trust Co. v. Hewitt Realty Co.*, a case involving a request to compel directors to declare dividends, the New York Court of Appeals drew a distinction between situations where the directors breached their trust, or acted in bad faith, or engaged in fraud, which warranted the court's intervention, and "questions of expediency" which the courts should not evaluate as "such questions are confided by the Legislature in the directors."[190]

Yet, while the courts protected the directors' discretion, they continued, through the early 1940s, to rely on heightened directors' duties to protect the corporation and its shareholders from abuse of such discretion. Directors were exempt from liability "for mere mistakes and errors of judgment," but required to exercise "proper care, skill, and diligence."[191] In fact, the conclusion of a 1942 article suggested that directors' duties had not changed much since *Hun v. Cary*. According to the author, "directors are not exonerated in the exercise of even a disinterested business judgment if they have been careless—have failed to exercise the prudence and degree of care which would be exercised in the circumstances by a reasonable man protecting his own interests."[192] Kessler, too, argued that the view that directors were representatives corresponded to "higher responsibilities, just as Platonic 'guardians' would be:

189. Holmes v. St. Joseph Lead Co., 147 N.Y.S. 104, 107 (Sup. Ct. 1914). For a more elaborate, and often quoted, description of the rule, see Pollitz v. Wabash R.R. Co. 100 N.E. 721, 724 (N.Y. 1912) ("Questions of policy of management, expediency of contracts or action, adequacy of consideration, lawful appropriation of corporate funds to advance corporate interests, are left solely to [the directors'] honest and unselfish decision, for their powers therein are without limitation and free from restraint, and the exercise of them for the common and general interests of the corporation may not be questioned, although the results show that what they did was unwise or inexpedient.").

190. City Bank Farmers Trust Co. v. Hewitt Realty Co., 177 N.E. 309, 311 (N.Y. 1931).

191. Wangrow v. Wangrow, 207 N.Y.S. 132, 136 (App. Div. 1924).

192. Ralph M. Carson, *Current Phases of Derivative Actions Against Directors*, 40 MICH. L. REV. 1125, 1142 (1942). *See also id.* at 1142-48 (citing cases where courts have found directors negligent); Rohrlich, *supra* note 81, at 1190 (noting that "[t]he tendency towards holding directors liable for negligent mismanagement had been a progressive one for some years, and the New Deal statutes and the recent cases carry it forward.").

They are bound by fiduciary duties to the corporation, if not necessarily to his shareholders." [193]

Such general statements neglected to recognize, however, the minute but significant changes that culminated in the 1940s with respect to the duty of care and the business judgment rule. Take, for example, *Litwin v. Allen*, a case involving allegations of breaches of the duty of loyalty as well as negligence. Justice Shientag of the Supreme Court of New York, Special Term, seemed unequivocal. First, he explained that "a director owes loyalty and allegiance to the company—a loyalty that is undivided and an allegiance that is influenced in action by no consideration other than the welfare of the corporation." [194] Moreover, Shientag stressed that loyalty was not enough. Rather, "in the discharge of his duties a director must, of course, act honestly and in good faith, but that is not enough. He must also exercise some degree of skill and prudence and diligence."[195] Specifically, Shientag explained that while directors were not liable for "errors of judgment or for mistakes while acting with reasonable skill and prudence," they were "liable for negligence in the performance of their duties."[196]

At the same time, however, Shientag chose to tweak the standard of care applicable to directors' actions. As Shientag saw it, his task in *Litwin* was to balance the need to protect the directors' discretion with the need to protect the corporation and its shareholders. He drew the balance by tailoring what he viewed as the appropriate standard of care. Specifically, he articulated a standard of care that gave directors more leeway than did earlier cases. Shientag required directors to act as prudent persons, or prudent directors, in similar circumstances (not the stricter standard mentioned above of the prudent person managing his own affairs). As Shientag put it:

> It has been said that a director is required to conduct the business of the corporation with the same degree

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193. Kessler, *supra* note 10, at 701. Kessler further noted that the directors' fiduciary duty to the corporation was "a proposition so universally accepted as not to require citation of authority." *Id.* at 701 n.28.

194. Litwin v. Allen, 25 N.Y.S.2d 667, 677 (Sup. Ct. 1940).

195. *Id.* at 677-78.

196. *Id.* at 678. In support of this statement, Shientag cited *Railroad Co. v. Lockwood* (1873), which was discussed in the second part of this article. *See supra* text accompanying notes 42-43.

of fidelity and care as an ordinarily prudent man would exercise in the management of his own affairs of like magnitude and importance. General rules, however, are not altogether helpful. In the last analysis, whether or not a director has discharged his duty, whether or not he has been negligent, depends upon the facts and circumstances of a particular case, the kind of corporation involved, its size and financial resources, the magnitude of the transaction, and the immediacy of the problem presented. A director is called upon "to bestow the care and skill" which the situation demands.[197]

197. *Litwin*, 25 N.Y.S.2d at 678. While Shientag did not reject the term "prudent person," his analysis suggests that he saw the standard as equivalent to the standard of the prudent director in similar circumstances. As he put it, "[u]ndoubtedly, a director of a bank is held to stricter accountability than the director of an ordinary business corporation. A director of a bank is entrusted with the funds of depositors, and the stockholders look to him for protection from the imposition of personal liability. But clairvoyance is not required even of a bank director. The law recognizes that the most conservative director is not infallible, and that he will make mistakes, but if he uses that degree of care ordinarily exercised by prudent bankers he will be absolved from liability although his opinion may turn out to have been mistaken and his judgment faulty." *Id.* (citation omitted) In this respect, it is also important to note that Shientag's decision in *Litwin* reflected a gradual development. In the 1910s and 1920s, New York courts required directors to act as prudent persons would act in the conduct of their affairs. *See, e.g.*, Tri-Bullion Smelting & Dev. v. Curtis, 174 N.Y.S. 830, 839 (App. Div. 1919) ("[D]irectors . . . were bound to use the same degree of care and vigilance in the performance of their duties as a reasonably prudent and careful man would use in the conduct of his business"); Bown v. Ramsdell, 237 N.Y.S. 573, 576 (App. Div. 1929) ("[D]irectors [are] personally answerable for losses resulting from ordinary neglect in their official duties; ordinary neglect being understood to be the omission of that care which every man of common prudence takes of his own concerns."). By the early 1930s, New York courts changed the standard from the prudent person to the prudent businessperson. *See, e.g.*, Walker v. Man, 253 N.Y.S. 458, 462 (Sup. Ct. 1931) (holding that directors are "bound generally to use every effort that a prudent business man would use in supervising his own affairs"); Simon v. Socony-Vacuum Oil Co., Inc., 38 N.Y.S.2d 270, 273 (Sup. Ct. 1942) ("It is elementary that directors owe a corporation the duty to exercise reasonable care in managing its affairs; that is, the same degree of care which a business man of ordinary prudence generally exercises in the management of his own affairs. If the directors fail to use such care, they are liable to the corporation for damages.").

Shientag's approach of tweaking the standard of liability would have continued to require a careful analysis of the directors' actions in each case. More devastating to the possibility of imposing liability on directors was the 1940s expansion of the business judgment rule. Perhaps due to their concerns about shareholders' growing employment of the derivative suit[198] or about securities regulation that granted shareholders more power, such as the shareholder proposal rule, and perhaps due to their embrace of managerialism, the New York courts chose to add new exemptions to directors' liability. Their efforts were informed by the vision of directors as representatives; their success complemented it.

Specifically, courts refrained from evaluating directors' actions in matters entrusted to their discretion even when the directors' errors were gross. Take as one example *Everett v. Phillips*, a suit by a minority shareholder of Empire Power Corporation to compel directors sitting both on its board and on the board of Long Island Lighting Company to demand payment of indebtedness from the lighting company to the power company. In determining that the directors did not violate their trust to the power company or its shareholders, the court noted that not merely innocent mistakes, which prudent persons might make, but also gross mistakes were protected from ex-post intervention by the courts:

> Power of control carries with it a trust or duty to exercise that power faithfully to promote the corporate interests, and the courts of this State will insist upon scrupulous performance of that duty. Yet, however high may be the standard of fidelity to duty which the court may exact, errors of judgment by directors do not alone suffice to demonstrate lack of fidelity. That is true even though the errors may be so gross that they may demonstrate the unfitness of the directors to manage the corporate affairs.[199]

198. *See* Carson, *supra* note 192, at 1126, 1158-60.

199. Everett v. Phillips, 43 N.E.2d 18, 19-20 (N.Y. 1942). While *Everett* involved a duty of loyalty claim, the statement quoted above applied both to duty of loyalty and duty of care situations. *See also* Rous v. Carlisle, 26 N.Y.S.2d 197, 200 (App. Div. 1941) ("If a director exercises his business judgment in good faith on the information before him, he may not be called to account through the judicial process, even though he may have erred in his

Gradually, exemptions to directors' liability were encroaching upon the standard of care applicable to their actions. As Shientag noted in 1944, "although the concept of 'responsibility' is firmly fixed in the law, it is only in a most unusualand extraordinary case that directors are held liable for negligence in the absence of fraud, or improper motive, or personal interest."[200]

As illustrated by his decision in *Casey v. Woodruff*, a case involving a suit to recover costs from corporate directors for proceedings before the Interstate Commerce Commission, Shientag wanted to resurrect whatever was left of the duty of care. "The fundamental concept of negligence does not vary," he wrote, "whether it is applied to the case of a simple personal injury action or to liability of directors in the management of the affairs of their corporation."[201] In both situations, Shientag stressed, "the law requires the use of judgment, the judgment of ordinary prudence."[202] Turning to the business judgment rule, he explained:

> The question is frequently asked, how does the operation of the so-called "business judgment rule" tie in with the concept of negligence? There is no conflict between the two. When courts say that they will not interfere in matters of business judgment, it is presupposed that judgment—reasonable diligence—has in fact been exercised. A director cannot close his eyes to what is going on about him in the conduct of the business of the corporation and have it said that he is exercising business judgment. Courts have properly decided to give directors a wide latitude in the management of the affairs of a corporation provided always that judgment, and that means an honest, unbiased judgment, is reasonably exercised by them.[203]

Despite attempts to keep the duty of care alive, the business judgment rule gained a force of its own. Rather than a

judgment. It is necessary, therefore, for the stockholder to allege facts showing more than error in business judgment.").

200. Bayer v. Beran, 49 N.Y.S.2d 2, 6 (Sup. Ct. 1944).

201. Casey v. Woodruff, 49 N.Y.S.2d 625, 643 (Sup. Ct. 1944).

202. *Id.*

203. *Id.* It should be noted that Shientag held that the directors in this case were not negligent.

rule grounded in the view that directors were representatives of the shareholders and, as such, should have broad discretion to manage the corporation, it became a means of exempting directors from liability, of changing the standard of liability applicable to their actions.[204] Not only honest mistakes but all actions, unless they were fraudulent or tainted with a conflict of interest, were exempt from liability. [205] The fourth part of this article explores the magnitude of this transformation. Beforehand, it is important briefly to explore how these 1940s changes affected not only the directors' liability but also the courts' vision of the directors' role. Gradually, the ideal of directors as representatives (and representative democracy more broadly) began to lose its force.

Take, *Bayer v. Beran*, a case involving a derivative suit brought by the shareholders of the Celanese Corporation of America against their directors for alleged breaches of their fiduciary duties. These allegations focused on the directors' approval of a radio advertising campaign in which the president's wife, a professional opera singer, was sometimes featured. The shareholders argued, first, that the directors were negligent in approving the campaign and, second, that the campaign was engaged in to further the career of the president's wife.[206]

Shientag began his discussion by stressing the importance of the derivative suit. The New York Chamber of Commerce expressed growing dissatisfaction with derivative suits in the early 1940s, convincing the New York legislature to pass a law

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204. *See, e.g.*, Kamin v. American Express Co., 86 MISC. 2d 809, 812-13 (1976). ("The directors' room rather than the courtroom is the appropriate forum for thrashing out purely business questions which will have an impact on profits, market prices, competitive situations, or tax advantages. . . . It is not enough to allege, as plaintiffs do here, that the directors made an imprudent decision, which did not capitalize on the possibility of using a potential capital loss to offset capital gains. More than imprudence or mistaken judgment must be shown.").

205. For an interesting analysis of the impact of the emergence of the modern business judgment rule on the duty of loyalty, *see* NELSON, *supra* note 2, at 297 (arguing that "the reification of the business judgment rule [in the early 1940s] probably gave judges a better basis than they previously possessed for declining to enforce the duty of loyalty . . . and instead, deciding cases 'on the practical basis' that entrepreneurs should be left free to manage corporations efficiently. . .").

206. Bayer v. Beran, 49 N.Y.S.2d 2, 7 (Sup. Ct. 1944).

that acutely circumscribed the ability of shareholders to pursue these suits.[207] Shientag's response was short and direct. His decision began with the following:

> Despite abuses that have developed in connection with the derivative stockholders' suit, abuses which should be dealt with promptly and effectively, it must be remembered that such an action is, at present, the only civil remedy that stockholders have for breach of fiduciary duty on the part of those entrusted with the management and direction of their corporations. We cannot therefore allow the prevailing mood of justifiable dissatisfaction with some of the temporary incidents of such suits to cause us to lose sight of certain deep-rooted, traditional concepts of the obligations of directors to their corporation and its stockholders.[208]

But Shientag's analysis of the directors' fiduciary duties took away whatever procedural protection he offered to the shareholders. First, Shientag addressed the appropriate obligations of directors to the corporation and its shareholders. "Directors of a business corporation are not trustees and are not held to strict accountability as such," Shientag proclaimed. Rather, as he put it, "directors are agents; they are fiduciaries." [209] As such, they had two obligations: "responsibility and loyalty." [210] As he noted in *Litwin*, the level of care and diligence required of directors as agents or fiduciaries was "proportioned to the occasion."[211]

Interestingly, Shientag labeled directors agents even though he viewed their status as analogous to the status of democratically elected representatives. He stressed that the power to manage the corporation was vested in the board and that the judicial role was to discourage shareholders from interfering with the directors' "free and independent judgment."[212] (As discussed in the first part of this article, if direc-

207. *See* Mitchell, *supra* note 178.
208. *Bayer*, 49 N.Y.S.2d at 4-5.
209. *Id.* at 5.
210. *Id.* at 2.
211. *Id.* at 3.
212. *Id.* at 6.

tors were agents of the shareholders, the latter, as principals, would determine the scope of their power.[213])

Beyond labels, Shientag also changed the requirements that the description of directors as representatives of the shareholders implied. With a nod to the general rule that directors as agents of the stockholders (and, more accurately, as their representatives) "are given by law no power to act except as a board,"[214] Shientag was willing to validate corporate decisions that did not follow this requirement. As he put it, "the failure to observe the formal requirements is by no means fatal."[215] In *Bayer*, despite the fact that no formal meeting was held to approve the advertising campaign prior to its introduction, Shientag proclaimed that the directors fulfilled their care and diligence responsibilities.[216]

A decade later, albeit in a different context, the Court of Appeals of New York went even further in eroding the status of directors as representatives. *Auer v. Dressel* was an action by stockholders to compel the corporation's president to call a special meeting, among other things, so that the shareholders could vote on a resolution endorsing the conduct of Mr. Auer as president and requesting that he be reinstated. While the selection of officers was within the realm of the directors' discretion, the court held that the shareholders could call a special meeting to express "their approval of Mr. Auer's conduct as president and their demand that he be put back in that office." [217] "It would be preposterous," the court reiterated, "to leave the real owners of the corporate property at the mercy of their agents."[218]

Judge Van Voorhis, in dissent, continued to endorse the notion that the directors' status was analogous to the electorate in democratic governments. As he announced, the statute provides that "the business of a corporation shall be managed by its board of directors."[219] Having been elected by the shareholders "for stated terms which have not expired," the board, not the stockholders, had the power to appoint the officers of

213. *See supra* Part I.D.
214. *Bayer*, 49 N.Y.S.2d at 11.
215. *Id.*
216. *Id.* at 10.
217. Matter of Auer v. Dressel, 118 N.E.2d 590, 593 (N.Y. 1954).
218. *Id.* at 593 (quoting Rogers v. Hill, 289 U.S. 582, 589 (1933)).
219. *Id.* at 595 (Van Voorhis J., dissenting).

the corporation. Accordingly, "for the stockholders to vote on the proposition would be an idle gesture."[220]

Despite Van Voorhis's and similar critiques, the tides were rapidly shifting. For purposes of allowing directors to act without interference from the shareholders, the vision of directors as representatives of the shareholders seemed to survive. But it was supplemented by a new set of ideas that helped shield the board from liability almost absolutely. As the fourth part of this article explains, by the 1970s the emergence of a new economic theory of the corporation, which recognized no internal power or hierarchy, gave rise to the idea that directors were not representatives but mere agents of the shareholders. As to the appropriate functions of directors as agents, the legal and business communities converged on the monitoring model of the board of directors. It rested on the assumption that directors could only monitor the executives, and that independent directors were best suited for this task. With a limited role came very limited, if any, liability. By the mid 1980s, the Delaware courts collapsed the duty of care into the business judgment rule; they declared that the business judgment rule altered the standard of care from negligence to gross negligence and made gross negligence a prerequisite for rebutting the presumption of the business judgment rule. Within a few years, these ideas were strongly cemented into U.S. corporate law.

IV.
THE BOARD AT CENTURY'S END, ONCE REMOVED: DIRECTORS AS LIMITED AGENTS

A. *A New Theory of the Firm*

Beginning in the late 1930s and continuing until the mid 1970s, Keynesian economics gained wide acceptance among American scholars. Predicated upon the belief that governments should not choose among competing, individual visions of the public good, it helped legitimate a regulatory shift from "planning" to "accepting existing consumer preferences" and

220. *Id.* at 594.

"manipulating aggregate demand."[221] Both those who criticized the early New Deal as only increasing the concentration of power in a few hands and those who criticized it as increasing government power found in the new consumer ideology a point of convergence. The former wanted to expand the regulatory functions of the administrative state to protect consumers and promote full production, while the latter wanted the state only to redress "weaknesses and imbalances in the private economy without directly confronting the internal workings of capitalism"— to "manage the economy without managing the institutions of the economy."[222]

In the 1940s, with totalitarianism in Europe, and scholars' growing concerns about the relationship between statism and tyranny, the compensatory, fiscal vision of the state, which entailed only limited power, became the more appealing one. At the same time, the economic boom produced by the war effort made the need for regulation less urgent. The economy seemed to do well without government interference. A vision of a free market, corrected on rare occasions by the state's fiscal hand, began to dominate economic thought.[223]

The growing academic faith in the power of economic markets to produce and serve the common good opened a door for the introduction of economics into corporate law. Neo-classical economists, who thus far had focused their theorizing efforts on markets, turned to the corporation's internal structure. Their new economic theory of the firm offered a picture of the corporation that fit the market-centered economic policies of the postwar years. Rather than putting management hierarchies or the need to constrain corporate power at the center of the corporate paradigm, the new economic theory of the firm found a way around hierarchical power and its consequent need for regulation. Drawing on microeconomics, it painted a picture of the corporation as a nexus of private, contractual relationships. This cleared the way for presumably egalitarian economic markets to become

221. Alan Brinkley, *The New Deal and the Idea of the State*, *in* THE RISE AND FALL OF THE NEW DEAL ORDER, 1930–1980 85, 92, 98 (Steve Fraser & Gary Gerstle eds., 1989).

222. *Id.* at 94, 87–97.

223. On these developments, *see id.* at 97–121; SANDEL, *supra* note 72, at 250–73; ALAN BRINKLEY, THE END OF REFORM: NEW DEAL LIBERALISM IN RECESSION AND WAR 154–65 (1995).

the relevant focal point.[224] The corporation was a collection of "disaggregated but interrelated transactions" among individuals or the convenient fiction of corporate entity in free and efficient markets.[225]

The new theory of the firm supported a shift of focus in scholarly debates from questions of power, influence, sanctions, and legitimacy to issues of cost reduction and profit maximization. [226] Its proponents reframed the problems of corporate power and hierarchies as the problem of the separation of ownership from control (or agency costs) and sought to demonstrate how capital markets could eliminate the concerns about efficiency associated with this separation. [227]

Take, for example, Daniel Fischel's 1982 examination of the corporate governance structure. Reiterating the new economic theory of the firm, Fischel began his analysis by noting that "[t]he publicly held corporation. . . is a type of firm that facilitates the organization of production which is particularly effective when a large amount of capital is required."[228] As he elaborated:

> Shareholders and bondholders provide firms [i.e., the corporation] with needed capital in exchange for an expected rate of return generated by cash flows from the firm's assets. Different groups provide other factors of production: employees supply labor, managers supply managerial talent necessary for coordinating the various inputs, and suppliers supply goods.[229]

Having so described the corporation, Fischel stressed the potential conflict of interest between shareholders, who wanted to maximize the return on their investment, and managers, who did not have a strong incentive to maximize the corporate wealth because, unless they were also shareholders, they did not capture the gains of such maximization. He fur-

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224. William W. Bratton, Jr., *The "Nexus of Contracts" Corporation: A Critical Appraisal*, 74 CORNELL L. REV. 407, 416–20 (1989).

225. *Id.* at 420.

226. William W. Bratton, Jr., *The New Economic Theory of the Firm: Critical Perspectives from History*, 41 STAN. L. REV. 1471, 1498 (1989).

227. Tsuk, *supra* note 76, at 212–15.

228. Daniel R. Fischel, *The Corporate Governance Movement*, 35 VAND. L. REV. 1259, 1262 (1982).

229. *Id.*

ther assessed different ways to reduce agency costs, including direct monitoring by independent directors that could limit "non-wealth maximizing behavior by manager-agents"[230] and managerial contracts that could limit the divergence of interests.[231] But, according to Fischel, adopting different mechanisms to reduce agency costs was unnecessary. Like other advocates of the new theory of the firm, Fischel emphasized that the market itself would best channel managerial power to act to the benefit of the corporation and its shareholders. As he put it:

> When a firm is profitable, the price of its shares will be high relative to comparable firms that are less efficiently run. This basic proposition has dramatic implications for the incentives of corporate managers to maximize the firm's profits. Since managers' compensation typically is positively correlated with profitability, they have strong incentives to operate efficiently and keep stock prices high. . . . The product and capital markets also constrain the divergence of interests between managers and investors. A firm that is inefficiently run will have a difficult time selling goods and services on the same terms as more efficiently run firms. Similarly, the poorly run firm will be at a disadvantage in raising equity capital. Even if the inefficient firm does not resort to the new equities market for needed capital, it still is at a disadvantage when negotiating with other sources of capital such as banks. In addition, if the price of a firm's shares falls too low relative to what it would be under superior management, an outsider may attempt to acquire the firm by merger or tender offer and install new managers. The operation of this market for corporate control simultaneously gives managers of all firms who wish to avoid a takeover an incentive to operate efficiently and to keep share prices high and

230. *Id.* at 1263.
231. *Id.* at 1264.

> provides a mechanism for displacing inefficient managers.[232]

Fischel was writing at the front end of the 1980s hostile takeovers. Within a couple of years, the Delaware courts were faced with a series of cases dealing with managerial defensive tactics that required them to determine their willingness to embrace the market, especially the market for control, as a means of taming corporate management. The courts' unequivocal answer was no. (It is important to note that, despite the role that Delaware's legislature played in creating U.S. corporate law, the Delaware courts did not play a significant role in developing the contours of the duty of care until the 1980s. Indeed, the Delaware courts' claim to fame was their analysis of the hostile tender-offer cases.) [233]

In *Unocal Corp. v. Mesa Petroleum Co.*, the seminal takeover case, the Delaware Supreme Court drew upon the board's "fundamental duty and obligation to protect the corporate enterprise" to create the power of the board to adopt defensive tactics that would thwart hostile takeovers (and the market for control).[234] As Justice Horsey put it four years later, in *Paramount Communications, Inc. v. Time, Inc.*:

> Delaware law confers the management of the corporate enterprise to the stockholders' duly elected board representatives. . . . That [fiduciary duty to manage a corporate enterprise] may not be delegated to the stockholders. Directors are not obliged to abandon a deliberately conceived corporate plan for a short-term shareholder profit unless there is clearly no basis to sustain the corporate strategy.[235]

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232. *Id.* at 1263-64. On Fischel's views, see Joel Seligman, *A Sheep in Wolf's Clothing: The American Law Institute Principles of Corporate Governance Project*, 55 GEO. WASH. L. REV. 325, 346-48 (1987).

233. *See infra* Part IV.D.

234. 493 A.2d 946 (Del. 1985). The court enumerated several provisions of the Delaware General Corporations Law as sources for the board's power but none of these provisions was explicitly meant to address takeovers.

235. 571 A.2d 1140, 1154 (Del. 1989) (citations omitted). For an intriguing analysis of *Paramount* see Jeffrey N. Gordon, *Corporations, Markets, and Courts*, 91 COLUM. L. REV. 1931, 1933 (1991) (arguing that "*Paramount* can best be understood as a judgment that a self-regulating market, such as an unbridled market in corporate control, threatens fundamental social values

Six years later, in *Unitrin, Inc. v. American General Corp.*, the Delaware Supreme Court empowered directors to fight all-cash, all-shares premium tender offers and, for all practical purposes, eliminated the market for control.[236] As the court saw it, as long as a proxy contest was a possibility, even a remote one, the market for control remained viable.[237]

In short, just as the academic community was turning away from the description of directors as Platonic masters, Delaware courts strongly embraced it, tweaking the market for control in the context where it mattered most—the hostile takeover context. [238] Yet, as the following sections elaborate, while the Delaware courts seemed to continue to embrace the 1940s conception of representative democracy, they also strongly endorsed one of the ideas that followed directly from the new economic theory of the firm and that rejected the conception of representative democracy altogether, namely, the idea that directors were agents of their shareholders. In so doing, the Delaware courts created dissonance within corporate law and helped pave the road for the ascendance of a particular model of the board—the monitoring model. The notion of an independent monitoring board helped jurists evade certain conceptual difficulties associated with the description of directors as agents. As I conclude, it also legitimated the courts' diminution of directors' liability almost to nothing.

B. *Directors as Agents*

Closely tied to the growing academic concern about the separation of ownership from control, and following directly

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such a loyalty, continuity, and community, and, that at the very least, takeover activity needed to be slowed down.").

236. 651 A.2d 1361 (Del. 1995).

237. *See id.* at 1382–83. For a discussion of the concerns *Unitrin* raises with respect to directors' fiduciary obligations, see Jeffrey N. Gordon, *Mergers and Acquisitions: "Just Say Never?" Poison Pills, Deadhand Pills, and Shareholders-Adopted Bylaws: An Essay for Warren Buffett*, 19 CARDOZO L. REV. 511 (1997).

238. For a critique of these cases launched by an ardent advocate of the new theory of the firm, see Henry G. Manne, *Cash Tender Offers for Shares—A Reply to Chairman Cohen*, 16 DUKE L.J. 231 (1967); Henry G. Manne, *In Defense of the Corporate Coup*, 11 N. KY. L. REV. 513 (1984). For an attempt to unify the takeover doctrine (albeit prior to *Unitrin*) in terms of allocation of power between directors, shareholders, and the courts, *see* Marcel Kahan, *Paramount or Paradox: The Delaware Supreme Court's Takeover Jurisprudence*, 19 IOWA J. CORP. L. 583 (1994).

from the new theory of the firm, was the idea that managers (directors and officers) were agents of the shareholders. As this section explains, the theory of agency that proved to be full of contradictions in the early twentieth century returned in full force at the century's end.

Perhaps the best articulation of the late twentieth century agency theory of the corporation was offered by Michael C. Jensen and William H. Meckling in their 1976 article, *Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure.* The article reintroduced the traditional rules of contracts into the study of firms and organizations, focusing on "the behavioral implications of the property rights specified in the contract between the owners and managers of the firm."[239]

Jensen and Meckling began by defining the agency relationship as "a contract under which one or more persons (the principal(s)) engage another person (the agent) to perform some service on their behalf which involves delegating some decision making authority to the agent." Every agency relationship involved agency costs, including "the monitoring expenditures by the principal. . . the bonding expenditures by the agent. . . [and] the residual loss." Having defined the general parameters of their theory, Jensen and Meckling wrote that "[s]ince the relationship between the stockholders and managers of the corporation fit the definition of a pure agency relationship, it should be no surprise to discover that the issues associated with the 'separation of ownership and control' in the modern diffuse ownership corporation are intimately associated with the general problem of agency."[240]

Writing about the economic concept of firms (rather than the legal concept of corporations), Jensen and Meckling did not distinguish between executives and directors. They lumped them together as managers. But corporate legal scholars were not troubled by such omission. Their application of Jensen and Meckling's theory of the firm to corporate law had a profound impact on the courts' understanding of the status of the board of directors in the last decades of the twentieth

239. Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure,* 3 J. FIN. ECON. 305, 308 (1976).

240. *Id.* at 309. *See also* Eugene F. Fama & Michael C. Jensen, *Agency Problems and Residual Claims,* 26 J. OF L. & ECON. 327 (1983).

century. As I elaborate below, the courts' acquiescence in the idea that directors were agents of their shareholders helped legitimate not only their deference to corporate directors but also their erosion of directors' liability. [241]

Blasius Industries, Inv. v. Atlas Corp., a case that involved a conflict between Atlas's board and Atlas's largest shareholder, Blasius, illustrates this point. In an attempt to prevent or at least delay Blasius from placing a majority of new directors on the board, Atlas's board increased its size by two and filled the newly created directorships.[242] Blasius brought suit challenging this action. Written at the tail end of the hostile takeovers decade, Chancellor Allen's decision began by reiterating the rule adopted in *Unocal Corp. v. Mesa Petroleum Co.* As Allen explained:

> A board may take certain steps. . . that have the effect of defeating a threatened change in corporate control, when those steps are taken advisedly, in good faith pursuit of a corporate interest, and are reasonable in relation to a threat to legitimate corporate interests posed by the proposed change in control.[243]

In other words, even when faced with a hostile takeover, the corporation was managed under the direction of its board of directors and the shareholders had no right to interfere with the board's discretion. But, Allen went on, the directors' power to respond to a hostile takeover, as any other power they possessed, was conferred upon them "as the agents of the shareholders."[244] Corporate law, Allen stressed, presumably rejecting the 1940s vision of directors, "does not create Platonic masters." [245] The shareholders, as principals, could view issues such as the one before the court differently than did the board and "[i]f they do, or did, they are entitled to employ the mechanisms provided by the corporation law and the Atlas certificate of incorporation" to advance their views.[246] Moreover, the

241. On the benefits of treating officers, as distinguished from directors, as agents, see Lyman P.Q. Johnson & David Millon, *Recalling Why Corporate Officers Are Fiduciaries*, 46 WM. AND MARY L. REV. 1597 (2005).

242. Blasius Indus. Inc. v. Atlas Corp., 564 A.2d 651, 655 (Del. 1988).

243. *Id.* at 659.

244. *Id.* at 663.

245. *Id.*

246. *Id.*

shareholders, in Allen's opinion, were entitled "to restrain their agents, the board, from acting for the principal purpose of thwarting that action."[247] Accordingly, the board's action in this particular case "constituted an unintended violation of the duty of loyalty that the board owed to the shareholders." [248]

One would be mistaken, however, to assume that Allen's decision in *Blasius* was meant fully to embrace the idea that directors were agents of the shareholders. If such were the case, directors would not be able to act without the explicit or, at least, implied consent of their principals. But, while Allen would not allow directors to affect the shareholders' ability to elect their agents, he was fully content to permit directors to prevent shareholders from selling their stock to a hostile bidder (a more meaningful action).[249] Indeed, the issue was one of legitimacy. Allen used agency theory to legitimate the status of directors as, ironically, Platonic masters. As he put it, the "shareholder franchise" was "the ideological underpinning

247. *Id.*

248. *Id.*

249. *See, e.g.*, Allen's decision in Paramount Commc'ns, Inc. v. Time, Inc., 1989 Del. Ch. LEXIS 77, at 89-90 (July 14, 1989) ("[T]he financial vitality of the corporation and the value of the company's shares is in the hands of the directors and managers of the firm. The corporation law does not operate on the theory that directors, in exercising their powers to manage the firm, are obligated to follow the wishes of a majority of shares. In fact, directors, not shareholders, are charged with the duty to manage the firm. . . . That many, presumably most, shareholders would prefer the board to do otherwise than it has done does not, in the circumstances of a challenge to this type of transaction, in my opinion, afford a basis to interfere with the effectuation of the board's business judgment"). *See also* Robert B. Thompson, *Shareholders as Grown-Ups: Voting, Selling, and Limits on the Board's Power to "Just Say No,"* 67 U. CIN. L. REV. 999, 1011-14 (1999) (noting the apparent inconsistencies between the Delaware courts' disempowerment of shareholders in the hostile takeover cases and their approach in cases such as *Blasius*). Thompson concludes that "Delaware has long preferred a corporate governance system that is very indirect. Directors, elected by the shareholders make almost all corporate decisions, including those relating to takeovers. Shareholders have a limited say by a limited ability to replace the directors. Just as shareholder views about a takeover can be channeled away from a selling decision and into a proxy decision, so can voting decisions be channeled into an annual meeting or perhaps requiring action at two annual meetings before shareholder decision-making can prevail. The growth in the role of institutional investors as shareholders has not been enough to move Delaware from its long-stated preference of indirect democracy." *Id.* at 1020. *See also* the discussion *supra* ca. notes 234-37.

upon which the legitimacy of directorial power rests." [250] While admitting that the shareholders' vote had often been dismissed "as a vestige or a ritual of little practical importance," Allen nonetheless stressed that

> [a] decision by the board to act for the primary purpose of preventing the effectiveness of a shareholder vote inevitably involves the question who, as between the principal and the agent, has authority with respect to a matter of internal corporate governance. . . . Judicial review of such action involves a determination of the legal and equitable obligations of an agent towards his principal. This is not. . . a question that a court may leave to the agent finally to decide so long as he does so honestly and competently; that is, it may not be left to the agent's business judgment.[251]

Directors, in short, were neither trustees nor representatives, but agents of the shareholders. Yet, the obligations derived from their status as agents were limited to allowing shareholders to exercise their voting power, a meaningless ritual at best. As I argue in the following section, at least in part, the monitoring model of the board, upon which the legal and business communities converged in the early 1980s, helped make this image of the directors as agents plausible. The monitoring model rested on the twin assumptions that the directors' actual function was to monitor the executives and that independent directors could best perform this function. While the courts did not explicitly make the connection, I argue that the independent directors, presumably without other ties to the corporation, made the ideas that the shareholders actually elected directors and thus that the directors were their agents less fictitious. At the same time, the courts' reliance on the independent directors' opinion helped them limit the liability imposed on the board as a whole.

C. *The Monitoring Board*

The monitoring model of the board emerged during the 1970s, a crucial decade in the development of corporate gov-

250. Blasius Indus. Inc. v. Atlas Corp., 564 A.2d 651, 659 (Del. 1988).
251. *Id.* at 659-60.

ernance. Amidst social and political upheaval, public-interest shareholder groups used the SEC's proxy and shareholder proposal rules to voice their opposition to corporate practices related to the Vietnam War as well as a wide array of "environmental, occupational safety, and employment policies."[252] At the same time, institutional investors became major players in corporate governance; by the end of 1978, they "owned 36.3% of all common and preferred stock outstanding," raising new questions about the control of corporate America.[253] In addition, several corporate bankruptcies, including the sudden and unexpected collapse of Penn Central, "the nation's largest railroad company and sixth largest industrial corporation," raised grave doubts about "the performance of corporate boards of directors."[254] Corporate scandals involving illegal political contributions revealed during the Watergate investigation exacerbated such doubts. [255] The number of corporations involved was so high that the SEC initiated a program that "allowed a firm that had made questionable or illegal payments to avoid an SEC enforcement action by conducting its own investigation of the payments."[256] Through 1981, almost four hundred firms voluntarily disclosed making such payments and SEC investigations found an additional sixty two firms to have done so.[257]

The corporate board was at the forefront of public and academic discussions.[258] A variety of studies concluded that the boards of directors of large and medium-sized corporations "had ceased to function as a meaningful check on the corporation's chief executive officer" [259]; they did not even have much say in selecting the executives, as the proxy machinery was controlled by management. Outside directors were ineffective. They were typically chosen from the same social networks as the top executives and sitting with the latter on several boards; they were thus unlikely to challenge the ex-

252. Seligman, *supra* note 232, at 328.
253. *Id.* at 329.
254. *Id.* at 329-30.
255. *Id.* at 333-34.
256. *Id.* at 335.
257. *Id.*
258. As an example of this growing attention, see Symposium, *Officers' and Directors' Responsibilities and Liabilities*, 27 Bus. Law. 1-178 (1972).
259. Seligman, *supra* note 232, at 330.

ecutives. Finally, studies revealed that most boards did not meet frequently enough to perform a meaningful role. [260]

Several proposals for reform followed. Some wanted more federal supervision and guidance. Former SEC Chairman William Cary proposed the enactment of federal "minimum standards" for officers and directors of firms of a certain size.[261] In a similar manner, Ralph Nader, Mark Green, and Joel Seligman reintroduced the idea that firms of a certain income and employee-base should be federally incorporated; the federal statute was to include specific requirements regarding board composition and the board's role. [262] More radically, Nader, Green, and Seligman sought to revive the Progressive idea that directors were trustees for the community and called for the representation of different corporate constituencies on the board. As Lawrence Mitchell writes, "the board remained as the last, best hope against the increasing displacement of all other interests by rampant managerialism."[263]

Other proposals focused on the composition of the board. Harvey Goldschmid suggested requiring boards to be composed entirely of outside directors who would review the executives' decisions.[264] And Peter Drucker proposed creating boards of "professional directors," "men or women of public standing and proven competence who, as members of the board, can be truly independent of management."[265]

Lawyers and business groups similarly emphasized the importance of the board's structure. In 1976 the American Bar Association's Committee on Corporate Laws, Section of Cor-

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260. *Id.* at 330-32. *See also* Horsey, *supra* note 19, at 991; Mitchell, *supra* note 9, at 22.

261. William L. Cary, *Federalism and Corporate Law: Reflections Upon Delaware,* 83 YALE L.J. 663, 700-03 (1974). *See also* Cary & Harris, *supra* note 3, at 66 (suggesting higher standard of care for inside directors).

262. RALPH NADER ET AL, TAMING THE GIANT CORPORATION (1976). In 1976 and 1977 Congress held hearings "on the need for a new federal corporate law," but ultimately the reforms embraced by the SEC were rather limited, requiring corporations to have independent audit committees and better corporate recordkeeping. Seligman, *supra* note 232, at 337-40. On the Progressive federal incorporation movement, see MITCHELL, *supra* note 69; Tsuk Mitchell, *supra* note 73, at 1516-17.

263. Mitchell, *supra* note 9, at 19-20.

264. Harvey J. Goldschmid, *The Greening of the Board Room: Reflections on Corporate Responsibility,* 10 COLUM. J.L. & SOC. PROBS. 15 (1973).

265. Horsey, *supra* note 19, at 991.

poration, Banking and Business Law, published a *Corporate Director's Guidebook.*[266] The *Guidebook* described directors as "overseers of the corporation and monitors of corporate management." [267] So that the board could fulfill these tasks, the *Guidebook* recommended that a significant number of outside directors serve on the board and that inside directors be prohibited from serving on the nominating, compensation, and audit committees.[268] The Business Roundtable, "reflecting the views of the heads of 180 corporations, most of which were on the 'Fortune 500' list," followed suit. In 1978, it published its recommendations for reform in *The Role and Composition of the Board of Directors of the Large Publicly Owned Corporation.* It, too, argued that the board had a monitoring role (although its responsibility extended beyond that role), and recommended that the board be composed of a majority of outside directors and that the audit and compensation committees be composed entirely of outside directors.[269]

The monitoring board was also the subject of Melvin Eisenberg's *The Structure of the Corporation,* perhaps the most important work on corporate law since Berle and Means's *The Modern Corporation and Private Property.* After surveying the managing potential of the board of directors, Eisenberg concluded that the modern board of directors could not perform the tasks traditionally assigned to it. In fact, owner-managers handled the affairs of closely held corporations while top executives managed those of the publicly held corporation. [270]

266. The *Guidebook* was published in the fall of 1976 (*Corporate Director's Guidebook,* 32 BUS. L. 5 (1976)) with a revised edition early in 1978 (*Corporate Director's Guidebook,* 33 BUS. L. 1591 (1978)).

267. *Corporate Director's Guidebook,* 1976, *supra* note 266, at 31; *see also Corporate Director's Guidebook,* 1978, *supra* note 232, at 1619; Seligman, *supra* note 232, at 340.

268. *Corporate Director's Guidebook,* 1976, *supra* note 266, at 33-37; *Corporate Director's Guidebook,* 1978, *supra* note 232, at 1622-27; Seligman, *supra* note 232, at 340. As Seligman further notes, "in 1978, the SEC required registered firms to disclose additional information about the independence of their directors, whether the firms had audit, nominating, and compensation committees, and whether an incumbent director had attended fewer than 75% of a firm's board meetings during the past fiscal year." *Id.*

269. Seligman, *supra* note 232, at 341-42.

270. Eisenberg made this argument earlier. Melvin A. Eisenberg, *Legal Models of Management Structure in the Modern Corporation: Officers, Directors, and Accountants,* 63 CAL. L. REV. 375, 376 (1975). The references below are to this earlier article.

Closely looking at the things that boards actually did, Eisenberg concluded that the real task of boards of directors was to hire and fire the CEO and to monitor the performance of senior management. Informed by such observations, Eisenberg rejected calls for reform that focused on professional directors, full-time directors, or fully staffed boards of directors.[271] Instead, his call for reform focused on the board's monitoring functions. Eisenberg wanted to create "oversight boards with adequate information to perform their task."[272]

On its face, the independent monitoring board might seem similar to the board that William O. Douglas imagined back in 1934. Like Douglas, Eisenberg, for example, wanted the board to be independent of management and to be capable of acquiring adequate information to assess the executives' actions.[273] But a significant conceptual difference separated the two models. In the 1930s, directors were described as the corporation's trustees, the shareholders' representatives, or both; they had managerial, specifically consultative, as well as monitoring roles. By the 1970s, the status of the board had dramatically changed. For one thing, Eisenberg's analysis stressed that the two preeminent roles of the board of directors were their selection and removal powers. "Under a monitoring model," he wrote, "the role of the board is to hold the executives accountable for adequate results (whether financial, social, or both), while the role of the executives is to determine how to achieve such results."[274]

By the early 1980s, academics, lawyers, and businessmen of all political convictions agreed that the monitoring model was appropriate for the board's role. The idea was reinforced with the 1982 publication of the tentative draft of the American Law Institute's *Principles of Corporate Governance* (the final version was adopted in 1992 after a decade-long heated debate). But the monitoring model upon which agreement was reached was very different from the one envisioned by Douglas or even Eisenberg. Consensus was limited to the fact that independent directors should play an important role in reviewing the activities of the executives, and that such review should fo-

271. *Id.* at 385-90.
272. *Id.* at 391-403.
273. Mitchell, *supra* note 9, at 25-28.
274. Eisenberg, *supra* note 270, at 399.

cus on financial results. What that meant as far as the duties and liabilities of directors, and to whom directors owed them, remained contested issues throughout the 1980s.[275]

Take, for example, Eisenberg's model. Eisenberg stressed that the monitoring model was not "mechanistic." While results mattered, monitoring did not end with results such as satisfactory profits. As he explained, "The concept of monitoring for results thus does not preclude the monitors from going behind the result and either accepting as satisfactory a level of performance which falls short of the applicable objective, or criticizing as unsatisfactory a level of performance which exceeds it."[276] The ABA saw matters differently. First, its *Guidebook* stressed that directors who acted in accordance with the *Guidebook*, "will not only be performing their directorial functions competently, but will also be reducing the risk of being charged with deficient individual performance as a director."[277] Moreover, as to the directors' scope of duties, the *Guidebook* emphasized that the directors' duties were toward the shareholders and shareholders only.[278]

Indeed, while some legal scholars wanted to use the monitoring model substantially to redefine the directors' duties, corporate lawyers and business groups were strongly opposed to any attempt to tinker with the very limited directorial duties. Instead, they focused on the monitoring role of non-management directors and suggested that good boards "contain a significant quota" of them. Moreover, as the business community saw it, the monitoring board had one task—the directors' role was "to monitor, in an environment of loyal but independent oversight, the conduct of the business and affairs of the corporation in behalf of those who invest in the corporation." Directors were not to be representatives of different corporate constituencies.[279] Indeed, according to the business community and its lawyers, the directors' monitoring powers went hand in hand with the ideal of share-price maximization. [280]

275. Mitchell, *supra* note 9, at 29-56.

276. Eisenberg, *supra* note 270, at 399.

277. *Corporate Director's Guidebook*, 1978, *supra* note 266, at 1597; *see also Corporate Director's Guidebook*, 1976, *supra* note 266, at 11.

278. *Id.*

279. Mitchell, *supra* note 9, at 30-34.

280. On the relationship between the monitoring board and share-price maximization, see Frank H. Easterbrook, *Managers' Discretion and Investors'*

During the 1980s, the Delaware courts brought the business community's version of the monitoring model to bear upon their analysis of directors' duties and the business judgment rule. Fully embracing the model as a structural rather than substantive one, the Delaware courts focused on the role of the independent directors (independence narrowly defined as lack of control or domination by an individual interested in the transaction).[281] If a majority of independent, disinterested directors, following the courts' procedural requirements, approved the board's actions (including conflict of interest transactions), the courts declared such actions to be shielded from further judicial inquiry.[282]

Interestingly, as Mitchell explains, the true beneficiaries of the Delaware courts' approach were the inside directors (management directors).[283] Take, again, the 1980s hostile tender offers, the context in which the Delaware courts endorsed the monitoring model of the board. When a hostile bidder made an offer to the target corporation's shareholders, the decision of the target corporation's directors to adopt a defensive tactic, on its face, was tainted with a conflict of interest because successful hostile bidders typically replaced the

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Welfare: Theories and Evidence, 9 DEL. J. CORP. L. 540, 555 (1984); Gordon, *supra* note 9; Ira M. Millstein and Paul W. MacAvoy, *The Active Board of Directors and Performance of the Large Publicly Traded Corporation*, 98 COLUM. L. REV. 1283, 1292-93 (1998).

281. Grobow v. Perot, 539 A.2d 180, 188-89 (Del. 1988). For an insightful analysis of "independence" under Delaware law, see Usha Rodrigues, *The Fetishization of Independence*, 33 J. OF CORP. L. 447 (2008). *See also* Alan R. Palmiter, *Reshaping the Corporate Fiduciary Model: A Director's Duty of Independence*, 67 TEX. L. REV. 1351 (1989) (advocating a director's separate duty of independence).

282. Moran v. Household Int'l, Inc., 500 A.2d 1346, 1356 (Del. 1985) (noting that when directors adopt a defensive tactic, their ability to fulfill their *Unocal* duties is "materially enhanced . . . where . . . a majority of the board favoring the proposal consisted of outside independent directors who have acted in accordance with the foregoing standards"); Revlon, Inc. v. MacAndrews & Forbes Holding, Inc., 506 A.2d 173, 176 n.3 (Del. 1986) (noting that "certain presumptions . . . generally attach to the decisions of a board whose majority consists of truly outside independent directors"); Paramount Commc'ns, Inc. v. Time Inc., 571 A.2d 1140, 1154 (Del. 1989) (noting that the evidence supporting the conclusion that in making its decision the Time's board was not uninformed "is materially enhanced by the fact that twelve of Time's sixteen board members were outside independent directors.").

283. Mitchell, *supra* note 9, at 56-60.

board. But, as Mitchell notes, "inside directors faced more serious conflicts than did outsiders. After all, the insiders derived their livelihoods from their positions with the target corporations."[284] And while outsiders might lose "some prestige," their "lucrative positions" were with their own corporations, corporations where they were insiders. [285] Given the potential conflict of interest, a decision by a board to engage in a defensive tactic should have been analyzed under the fairness test as any other form of self-dealing. But, beginning with *Unocal Corp. v. Mesa Petroleum Co.*, the Delaware courts adopted a more lenient test—a two prong test assessing, first, whether the directors "had reasonable grounds for believing that a danger to corporate policy and effectiveness existed," and, second, whether the defensive tactic the board adopted was "reasonable in relation to the threat posed."[286] More important, the Delaware courts emphasized that if a majority of the independent directors endorsed the defensive tactic, then the board's action would likely meet the burden of the *Unocal* test.[287] As Mitchell concludes, the "cleansing effect" or "protective effect" of the independent directors

> allowed the courts to look not at the substance of the actions but the procedures pursuant to which they had been taken. Good process—decisionmaking by reasonably informed, rational, independent boards—allowed the courts entirely to bypass the substance of the decisionmaking and even the substance of the process of the decisionmaking.[288]

In short, "[d]irectors serving on properly composed monitoring boards behaving in accordance with the model were almost exempt from liability."[289] As the following section explores, the Delaware courts went further. They collapsed the duty of care into the business judgment rule and proclaimed, without precedent to support their announcement, that the

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284. *Id.* at 57.
285. *Id.*
286. 493 A.2d 946, 955 (Del. 1985).
287. *See, e.g.*, cases cited *supra* note 282.
288. Mitchell, *supra* note 58, at 58.
289. *Id. But see* Stephen M. Bainbridge, Unocal *at 20: Director Primacy in Corporate Takeovers*, 31 DEL. J. CORP. L. 769 (2006) (arguing that *Unocal* struck a careful balance between the board's authority and its accountability).

business judgment rule altered the standard of care from negligence to gross negligence. If up to the 1980s directors might have been held liable for violations of the duty of care (although they seldom were),[290] by the end of the decade such possibility was nonexistent.

D. *The Business Judgment Rule and the Dormant Duty of Care*

Up to the 1960s, the New York courts directed the formulation and development of the duty of care. As Justice Horsey writes, "No Delaware court decision espouses the existence of a director's fiduciary duty to act in an informed manner and with the care of a prudent man until the decision of our separately constituted supreme court in 1963 in *Graham v. Allis-Chalmers Manufacturing Co.*" [291]

Graham was a derivative suit against the directors of Allis-Chalmers Mfg. Co. for damages caused to the corporation by the non-director employees' and the corporation's violations of antitrust regulations.[292] Justice Wolcott of the Delaware Supreme Court began his analysis by noting that, based on precedent,

> it appears that directors of a corporation in managing the corporate affairs are bound to use that amount of care which ordinarily careful and prudent men would use in similar circumstances. Their duties are those of control, and whether or not by neglect they have made themselves liable for failure to exer-

290. As Horsey points out, before the 1980s, only in "a handful of cases outside the context of financial institutions . . . directors of business corporations had been found liable for breach of their duty of care." Horsey, *supra* note 19, at 978. For the most part, commentators agree that "the business judgment rule has historically proved to be 'a very potent defense for corporate directors and officers against claims primarily asserted by shareholders for loss resulting from decisions that went awry.'" *Id.* at 978-80.

291. *Id.* at 982-83. *See also* Johnson, *supra* note 181, at 639 (noting that *Graham* was the first Delaware case "explicitly [to] acknowledge" the duty of care). According to Johnson, Delaware lacked "a judicially articulated duty of care until the 1960s." Hence, "Delaware's law on the business judgment rule developed before that time with no explicit connection to that vital duty." *Id.* at 625.

292. These employees and the corporation entered guilty pleas to the antitrust indictments. Graham v. Allis-Chalmers Mfg. Co., 188 A.2d 125 (Del. 1963).

cise proper control depends on the circumstances and facts of the particular case.[293]

As discussed above, courts had endorsed the standard of the prudent person at least since the early twentieth century.[294] Throughout the 1960s and 1970s, the Delaware courts continued to suggest that the standard by which violations of the duty of care would be evaluated was the ordinary negligence standard endorsed in *Graham*. But *Graham*, a case involving directorial inaction, did not address the question of the business judgment rule as no business decision was made. Interestingly, while they neglected to develop the doctrinal precepts of the duty of care, at the time that *Graham* was decided, the Delaware courts had already developed a "'business judgment' jurisprudence" independent of that duty.[295] As I argue below, after *Graham*, as the Delaware courts attempted to define the relationship between their developed business judgment rule and their underdeveloped duty-of-care jurisprudence, they lay the foundation for the obliteration of the latter.[296]

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293. *Id.* at 130.

294. Interestingly, just as it endorsed this standard of care, *Graham* added an exception to directors' liability. Citing to the U.S. Supreme Court's decision in *Briggs* (1891) (discussed in Part II.B. above), Wolcott proclaimed that directors "are entitled to rely on the honesty and integrity of their subordinates until something occurs to put them on suspicion that something is wrong. . . . [A]bsent cause for suspicion there is no duty upon the directors to install and operate a corporate system of espionage to ferret out wrongdoing which they have no reason to suspect exists." *Id.* Just as monitoring was becoming the board's only task, the court limited the directors' liability for performing it.

295. Johnson, *supra* note 181, at 639. *See also* A. Gilchrist Sparks, III, *Symposium: Southeastern Conference on Corporate and Securities Law: II. Fiduciary Obligations in the Corporate Boardroom: Recent Developments in Substantive Business Judgment Rule*, 61 N.C.L. Rev 534, 534 (1983) (arguing that "[A] great deal of the development of the business judgment rule occurred from the turn of the century through the 1940s and 1950s" and then again in the 1980s. According to Sparks, "During the 1960s and the early part of the 1970s, the federal securities laws were at their apogee, and most of the scholarly writing and many of the case decisions focused on the expanding scope of rule 10b-5, which before *Santa Fe Industries, Inc. v. Green* was thought by many to be subsuming much of the state law covering the business judgment rule. Only after the *Santa Fe* decision in 1977, which reemphasized the role of state law, did there appear to be a renewed interest in the business judgment rule.").

296. *See also* Johnson, *supra* note 181, at 642-43 (noting that in the last two decades of the twentieth century, the Delaware courts shrank the duty of

As late as the 1970s, the business judgment rule in Delaware seemed to be grounded in deference to the directors' expert knowledge.[297] Take, for example *Chasin v. Gluck*, a case involving an action by a shareholder of a subsidiary against the subsidiary's directors for failing to demand that the parent corporation make timely payments of amounts due to the subsidiary. The Delaware Chancery Court held that when a director was in a position freely to exercise independent business judgment, he would not be held liable absent "bad faith, negligence, or gross abuse of discretion." [298] But, as this quote also suggests, to benefit from the presumption of expertise, directors had to exercise reasonable diligence and care. As S. Samuel Arsht concluded in his well-known article *The Business Judgment Rule Revisited*:

> the term "business judgment rule" and the presumption that often identifies it mean simply that a stockholder who challenges a nonself-dealing transaction must persuade the court that the corporation's directors, officers, or controlling stockholders in authorizing the transaction did not act in good faith, did not act in a manner they reasonably believed to be in the corporation's best interest, or did not exercise the care an ordinarily prudent person in a like position would use under similar circumstances.[299]

Things changed dramatically in the 1980s, a decade in which, as already noted, numerous corporations faced hostile takeovers. Seeking to protect the directors' discretion to say no

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care to the duty to be informed, a requirement they derived from their developed business judgment rule doctrine).

297. The same seemed to be true in New York. Take, for example, *Kamin v. American Express Co.*, a case that embraced a rather all-encompassing business judgment rule. While noting that courts would not interfere with directors' actions "unless the powers have been illegally or unconscientiously executed or unless it be made to appear that the acts were fraudulent or collusive and destructive of the rights of the stockholders," the Supreme Court of New York, Special Term, also described the business judgment rule as a rule of deference. As the court put it, "mere errors of judgment [were] not sufficient as grounds for equity interference for the powers of those entrusted with corporate management are largely discretionary." Kamin v. American Express Co., 86 MISC. 2d 809, 810 (1976).

298. Chasin v. Gluck, 282 A.2d 188, 192 (1971). For a detailed discussion of *Chasin* and other cases, *see* Arsht, *supra* note 20, at 102-11.

299. Arsht, *supra* note 20, at 134.

to hostile bidders, the Delaware courts turned their attention, generally, to the business judgment rule and its relationship to the duty of care. [300] *Aronson v. Lewis*, a case involving the question of demand futility, addressed this issue.[301] Having determined that "demand can only be excused where facts are alleged with particularity which creates a reasonable doubt that the directors' action was entitled to the protections of the business judgment rule,"[302] the Delaware Supreme Court went on to define the meaning of the business judgment rule. It did so as a way of offering instructions to the lower courts as to how to assess this particular case and others. The court began by noting that:

> the business judgment rule is an acknowledgment of the managerial prerogatives of Delaware directors. . . . It is a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company. Absent an abuse of discretion, that judgment will be respected by the courts. The burden is on the party challenging the decision to establish facts rebutting the presumption.[303]

Having anchored the business judgment rule in "managerial prerogative" (in line with the mid century deference to directors' expert opinion) and emphasized that only disinterested directors could claim the protection of the rule (also in accordance to precedent), the Delaware Supreme Court went further. First, the court stressed that "to invoke the rule's protection directors have a duty to inform themselves, prior to

300. *See* DENNIS J. BLOCK, NANCY E. BARTON, AND STEPHEN A. RADIN, THE BUSINESS JUDGMENT RULE: FIDUCIARY DUTIES OF CORPORATE DIRECTORS AND OFFICERS 3 (2nd ed. 1988) (noting that the 1980s have "seen the business judgment rule become the center of rapid development and controversy in the corporate world as the courts struggle to adapt the rule to transactions involving corporate control and the termination of shareholder litigation by special board committees."). Even *Smith v. Van Gorkom*, which held directors liable for breach of the duty of care in a friendly takeover situation, seemed to support the conclusion that the court was attempting to empower incumbent directors to say no to bidders. Jonathan R. Macey & Geoffrey P. Miller, *Trans Union Reconsidered*, 98 YALE L. J. 127, 138-39 (1988).

301. Aronson v. Lewis, 473 A.2d 805 (Del. 1984).

302. *Id.* at 808.

303. *Id.* at 812.

making a business decision, of all material information reasonably available to them. Having become so informed, they must then act with requisite care in the discharge of their duties."[304] Moreover, the court went on to announce that "while the Delaware cases use a variety of terms to describe the applicable standard of care, our analysis satisfies us that under the business judgment rule director liability is predicated upon concepts of gross negligence."[305]

As Lyman Johnson has pointed out, the "informed" element was not part of the business judgment rule doctrine until *Aronson* introduced it. In adding it, *Aronson* lay the foundation for the ultimate equation of the duty of care with the duty to be informed.[306] Precedent also did not support the court's conclusion that gross negligence was the standard of care applicable to directors. As Arsht's review of Delaware cases a few years before *Aronson* was decided revealed, most of the cases cited in *Aronson* dealt with "parent-subsidiary transactions where a determination of fairness is meaningless or impossible."[307] In these situations, the courts had "characterized the standard of 'gross and palpable overreaching' as a 'business judgment' test."[308] But, as Arsht demonstrated, this was not a generally applicable test.[309] Other cases cited in *Aronson* simply stated that the court would not interfere with the board's judgment absent evidence of fraud or gross abuse of discre-

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304. *Id.*

305. *Id. See also* Johnson, *supra* note 181, at 643 n.81 (noting that this sentence captured "*Aronson*'s functional conflating of the duty of care and the business judgment rule.").

306. Johnson, *supra* note 181, at 641-42. According to Johnson, *Aronson* changed the traditional presumption that directors acted "in good faith, in the exercise of their best judgment, for what they believed to be the advantage of the corporation and all its stockholders" into a presumption that "in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company." *Id.* at 640. For the traditional formulation of the rule see, e.g., Bodell v. Gen. Gas & Elec. Corp. 140 A. 264, 268 (Del. 1927).

307. Arsht, *supra* note 20, at 102.

308. *Id.*

309. *Id.* at 102-7 (discussing Meyerson v. El Paso Natural Gas Co. 246 A.2d 789, 793 (Del. 1967), Getty Oil. Co. v. Skelly Oil Co., 267 A.2d 883, 887 (Del. 1970), and Sinclair Oil Corp. v. Levien 280 A.2d 717, 720 (Del. 1971)).

tion.[310] One case suggested that directors might be liable for gross negligence, but did not negate the possibility of liability for negligence. [311] Even the Delaware Supreme Court admitted that "the Delaware cases have not been precise in articulating the standard by which the exercise of business judgment is governed."[312] Nonetheless it chose to characterize the cases as "hold[ing] that director liability is predicated on a standard which is less exacting than simple negligence."[313]

Aronson v. Lewis radically changed the contours of the business judgment rule and duty of care. A year later, in *Smith v. Van Gorkom*, the case that shocked the business and legal communities by finding directors liable for breach of the duty of care, the Supreme Court of Delaware confirmed its own proclamation in *Aronson* that "under the business judgment rule director liability is predicated upon concepts of gross negligence." [314] Moreover, the court in *Van Gorkom* concluded that "the concept of gross negligence is also the proper standard for determining whether a business judgment reached by a board of directors was an informed one."[315] Unless a plaintiff arguing a breach of the duty of care demonstrated that the directors were grossly negligent (that is, grossly negligent with respect to the requirement to be informed), the directors would have the presumption of the business judgment rule and the court would not second-guess their actions.[316] In short, a rule that originated in an understanding of human fallibility, and transformed into a rule of deference to expert opinion, had become, by century's end, a defense precluding judicial inquiry into the directors' challenged actions.[317]

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310. Warshaw v. Calhoun, 221 A.2d 487, 492-93 (Del. 1966); Moskowitz v. Bantrell, 190 A.2d 749, 750 (Del. 1963); Kors v. Carey, 158 A.2d 136, 140 (1960).

311. Penn Mart Realty Co. v. Becker, 298 A.2d 349, 351 (Del. 1972).

312. *Aronson*, 473 A.2d at 812 n.6.

313. *Id.* Commentators also disagreed about the standard of care that different cases endorsed. Veasey and Manning, *supra* note 3, at 926-28.

314. Smith v. Van Gorkom, 488 A.2d 858, 873 (1985).

315. *Id.* Interestingly, what "gross negligence" meant remained an open question. Rabkin v. Philip A. Hunt Chem. Corp., 547 A.2d 963, 970 (1986).

316. For the endorsement of similar language in other jurisdictions, see BLOCK, BARTON & RADIN, *supra* note 300, at 9-10.

317. *See* Arsht, *supra* note 20, at 100 ("[T]he business judgment rule was not conceived as a defense that, once asserted, precluded judicial inquiry into the procedures and methodologies followed by the directors in making

Conceptually, the new vision of the business judgment rule was the logical result of treating directors as agents. While the idea that directors were representatives of the shareholders correlated well with a rule of deference to their expert judgment, the notion that directors were agents undermined such deference. As agents, directors could not be presumed to be experts. They could only be described as performing the tasks assigned to them by their principals, the shareholders. In such context, the business judgment rule could only be a means of protecting directors from their principals when the latter challenge how the task was performed; it could only be a rule shielding directors from liability.

Ironically, perhaps, it was not *Van Gorkom*'s formulation of the business judgment rule but rather its holding directors liable for breach of the duty of care that took the legal and business communities entirely by surprise. And the Delaware legislature was quick to respond. Within months it enacted section 102(b)(7), allowing corporations to include in their charters provisions that limit, or even eliminate, the personal liability of directors for almost all breaches of the duty of care. Other jurisdictions followed suit.[318]

But, as became clear within a decade after *Van Gorkom* was decided, the concerns that led to the enactment of such exculpatory provisions were overdrawn. Within a few years, the Delaware courts, using *Aronson* as their precedent, reduced the duty of care to a bare minimum. Not only was the bar of gross negligence hard to meet, the courts also shrank the duty of care to the requirement that directors be informed, a duty they could easily fulfill by following the script provided in *Van Gorkom.*[319]

Cede v. Technicolor, in which the plaintiff shareholder argued that the Technicolor directors breached their duty of care in entering a merger agreement, illustrates this point. In

their challenged decision." Rather "the business judgment rule was a starting point for inquiry into the directors' decisionmaking process.").

318. *See* MARK A. SARGENT & DENNIS R. HONABACH, D & O LIABILITY HANDBOOK (Thompson West ed., 2008) (discussing other jurisdictions that adopted similar provisions).

319. Johnson, supra note 181, at 633. *See also* Emerald Partners v. Berlin, 787 A.2d 85, 91 (2001) ("The statutory enactment of section 102(b)(7) was a logical corollary to the common law principles of the business judgment rule.").

its analysis of the duty of care, the Delaware Supreme Court brought together the different aspects of Delaware's late twentieth century approach. First, the court noted that "[t]he elements, formulation and application of the Delaware business judgment rule follow from the premise that shareholders of a public corporation delegate to their board of directors responsibility for managing the business enterprise."[320] In other words, in its final (liability shielding) reiteration, the business judgment rule was derived from the idea that directors were agents of the shareholders. Second, the court noted that only disinterested directors "who have both adequately informed themselves before voting on the business transaction at hand and acted with the requisite care" could invoke the rule.[321]

Then, lest it be misunderstood, the court described the relationship between the requirement that directors be informed and the duty of care. "The duty of the directors of a company to act on an informed basis," the court explained, "forms the duty of care element of the business judgment rule."[322] As to the standard applicable to the duty to be informed (now equated with the duty of care), the court, following *Aronson*, adopted the gross negligence standard.

If anything was left of the judicially developed duty of care after *Cede*, Chancellor Allen's contemporaneous decision in *In re Caremark, Int'l Inc. Derivative Litigation* made obvious its irrelevance:

> What should be understood, but may not widely be understood by courts or commentators who are not often required to face such questions, is that compliance with a director's duty of care can never appropriately be judicially determined by reference to *the*

320. Cede & Co. v. Technicolor, 634 A.2d 345, 367 (Del. 1993).

321. *Id.*

322. *Id. See also* Lyman Johnson, *Rethinking Judicial Review of Director Care*, 24 DEL. J. CORP. L. 787, 803-5 (1999) (discussing the duty of care in *Cede*). As Johnson points out, *Cede*'s conflation of the duty of care and business judgment rule, and the courts' reduction of both to the duty to be informed, shrank the duty of care almost to nothing. *Id. See also* Johnson, *supra* note 181, at 633 ("*Cede*'s analytical framework creates confusion, first, by seeming to forget that the duty of care and the business judgment rule, although complementary, are two distinct legal concepts serving different roles. Second, by treating the rule as an all-purpose metric for gauging director liability, *Cede* devalues the duty of care.").

> *content of the board decision* that leads to a corporate loss, apart from consideration of the good faith or rationality of the process employed. That is, whether a judge or jury considering the matter after the fact, believes a decision substantively wrong, or degrees of wrong extending through "stupid" to "egregious" or "irrational", provides no ground for director liability, so long as the court determines that the process employed was either rational or employed in a *good faith* effort to advance corporate interests. To employ a different rule—one that permitted an "objective" evaluation of the decision—would expose directors to substantive second guessing by ill-equipped judges or juries, which would, in the long-run, be injurious to investor interests. Thus, the business judgment rule is process oriented and informed by a deep respect for all *good faith* board decisions.[323]

Allen's reintroduction of good faith was an attempt, perhaps, to resurrect aspects of the duty of care for which directors might be held personally liable after section 102(b)(7) and *Cede*. Allen declared that the business judgment rule would protect decisions that were "the product of a process" that was either rational or "deliberately considered in good faith."[324] He went further to argue that, with respect to their monitoring obligations, directors had a duty to "exercise a good faith judgment that the corporation's informationand reporting system is in concept and design adequate to assure the board that appropriate information will come to its attention in a timely manner as a matter of ordinary operations, so that it may satisfy its responsibility."[325]

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323. *In re* Caremark Int'l, 698 A.2d 959, 967-68 (Del. Ch. 1996).

324. *Id.* at 967.

325. *Id.* at 970. *See also* Sarah Helene Duggin and Stephen M. Goldman, *Restoring Trust in Corporate Directors: The Disney Standard and the "New" Good Faith*, 56 AM. U.L. REV. 211, 232-37 (2006) (discussing the emergence of good faith after the enactment of §102(b)(7)); Hillary A. Sale, *Monitoring Caremark's Good Faith*, 32 DEL. J. CORP. L. 719 (2007) (discussing *Caremark*'s contribution to the development of the good faith standard). For an innovative analysis of the benefits of the business judgment's rule emphasis on process, *see* Lynn A. Stout, *In Praise of Procedure: An Economic and Behavioral Defense of Smith v. Van Gorkom and the Business Judgment Rule*, 96 NW. U.L. REV. 675 (2002).

In a footnote, Allen put the duty of care to sleep. "The vocabulary of negligence while often employed," he noted, citing to *Aronson*, "is not well-suited to judicial review of board attentiveness," especially, albeit not only, if such usage implies looking at the substance of the decision "as any evidence of possible 'negligence.'"[326] A standard of care no longer attached to the directors' duty of care. As long as directors, insiders and outsiders alike, follow the scripts that the Delaware courts had provided them throughout the 1980s, the Delaware courts would not reevaluate their decisions.

EPILOGUE

> Upon long and careful consideration, I am of the opinion that the concept of *intentional dereliction of duty*, a *conscious disregard for one's responsibilities*, is an appropriate (although not the only) standard for determining whether fiduciaries have acted in good faith. Deliberate indifference and inaction *in the face of a duty to act* is, in my mind, conduct that is clearly disloyal to the corporation. It is the epitome of faithless conduct.[327]

Having introduced, or reintroduced, the concept of good faith as a means of resurrecting the dormant duty of care, the Delaware courts were faced with the challenge of defining the duty to act in good faith. *In re Walt Disney Co. Derivative Litigation* offered a golden opportunity to address the matter. The key question in the case was whether Disney's board of directors breached their duties by hiring Michael Ovitz as president and firing him fourteen months later with a severance package of roughly $130 million. Earlier in the litigation, the court dismissed the duty of loyalty claims. At the same time, Disney's charter exempted directors from liability for breach of the duty of care (pursuant to section 102(b)(7) of the Delaware General Corporation Law). Hence, resurrecting a separate good faith standard was the only means of imposing liability on the board of directors. Chancellor Chandler was skillful in crafting such standard (although, ultimately, without imposing liability in the case before him), and the Delaware Supreme

326. *Caremark*, 698 A.2d at 967.
327. *In re* Walt Disney Co. Derivative Litig., 907 A.2d 693, 755 (Del. Ch. 2005).

Court affirmed. According to *Disney*, a director might fail to act in good faith if he or she "intentionally acts with a purpose other than that of advancing the best interests of the corporation," "acts with the intent to violate applicable positive law," or "intentionally fails to act in the face of a known duty to act, demonstrating a conscious disregard for his duties." [328] The latter possibility was particularly pertinent in *Disney*, but the court, even if reluctantly, determined that the Disney directors did not fail to fulfill their duty of good faith.[329]

Developments past *Disney* seem to have undermined the potential force of its good faith analysis.[330] For my argument in this article, however, *Disney* remains crucially important for a different reason–for Chandler's candid comments about the state of directors' duties and liabilities at the turn of the twenty-first century. Chandler began his analysis with the following apology:

Unlike ideals of corporate governance, a fiduciary's duties do not change over time. How we understand those duties may evolve and become refined, but the duties themselves have not changed, except to the extent that fulfilling a fiduciary duty requires obedience to other positive law. This court strongly encourages directors and officers to employ best practices, as those practices are understood at the time a corporate decision is taken. But Delaware law does not—indeed, the common law cannot—hold fiduciaries liable for a failure to comply with the aspirational ideal of best practices. . . ."[331]

As this article has explored, the directors' role, status, and fiduciary obligations have dramatically changed over time. In the course of one century, directors have turned from trustees

328. *Id.* at 755, *aff'd*, 906 A.2d 27, 67 (Del. 2006).

329. *Id.*

330. In 2006, in *Stone v. Ritter*, a case in which shareholders charged directors with failure to exercise oversight, the Delaware Supreme Court addressed an important question that *Disney* left open—"whether a violation of the duty to act in good faith is a basis for the direct imposition of liability." Stone *ex rel.* AmSouth Bancorporation v. Ritter, 911 A.2d 363, 369 (2006). The court answered this question in the negative. As the court saw it, the duty to act in good faith was not an independent duty, on the same footing as the duty of care and duty of loyalty. Accordingly, only the duty of care and duty of loyalty, "where violated, may directly result in liability, whereas a failure to act in good faith may do so, but indirectly." *Id.* at 370. Failure to act in good faith was subsumed under the duty of loyalty.

331. *In re* Walt Disney, 907 A.2d at 697.

for the community to representatives of the shareholders to agents whose obligations and liabilities have been so limited that all that is left for the court to do in cases involving allegations of breaches of fiduciary duties is to dismiss the suit. No longer the subject of "the punctilio of an honor the most sensitive," directors are expected to use "the morals of the market place" as their guideline.[332] The Delaware courts began their ascendance as the voice of corporate law only in the last decades of the century. But their alteration of the directors' duties was swift and effective. Having eradicated any concept of trust or even representation to bind directors to the corporation and its shareholders, all that the Delaware courts have left to elaborate are ideals they are unwilling to enforce.

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332. Mendes Hershman, *Opening Remarks*, 27 Bus. Law. 1, 1 (1972) (citing Cardozo in Meinhard v. Salmon, 164 N.E. 545, 546 (1928)).